PREFATORY NOTE

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Meeting of the Federal Open Market Committee

December 19-20, 1983

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Monday, December 19, 1983, at 3:00 p.m., and continuing on Tuesday, December 20, 1983, at 9:00 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Solomon, Vice Chairman
Mr. Gramley
Mr. Guffey
Mr. Keehn
Mr. Martin
Mr. Morris
Mr. Partee
Mr. Rice
Mr. Roberts
Mrs. Teeters
Mr. Wallich

Messrs. Boehne, Boykin, Corrigan, and Mrs. Horn, Alternate Members of the Federal Open Market Committee

Messrs. Balles, Black, and Forrestal, Presidents of the Federal Reserve Banks of San Francisco, Richmond, and Atlanta, respectively

Mr. Axilrod, Staff Director and Secretary
Mr. Bernard, Assistant Secretary
Mrs. Steele, Deputy Assistant Secretary
Mr. Bradfield, General Counsel
Mr. Oltman, Deputy General Counsel
Mr. Kichline, Economist
Mr. Truman, Economist (International)

Messrs. R. Davis, T. Davis, Eisenmenger, Prell, Siegman, Scheld, and Zeisel, Associate Economists

Mr. Cross, Manager for Foreign Operations, System Open Market Account
Mr. Sternlight, Manager for Domestic Operations, System Open Market Account

Mr. Coyne, Assistant to the Board of Governors
Mr. Roberts, Assistant to the Chairman, Board of Governors
Mr. Kohn, Deputy Staff Director, Office of Staff Director for Monetary and Financial Policy, Board of Governors
Mr. Gemmill, Senior Associate Director, Division of International Finance, Board of Governors
Mr. Lindsey, Associate Director, Division of Research and Statistics, Board of Governors
Mrs. Low, Open Market Secretariat Assistant, Board of Governors

Messrs. Burns, J. Davis, Koch, Mullineaux, Keran, and Stern, Senior Vice Presidents, Federal Reserve Banks of Dallas, Cleveland, Atlanta, Philadelphia, San Francisco, and Minneapolis, respectively

Messrs. Broaddus and Burger, Vice Presidents, Federal Reserve Banks of Richmond and St. Louis

Mr. McCurdy, Research Officer, Federal Reserve Bank of New York

Transcript of Federal Open Market Committee Meeting of
December 19-20, 1983

December 19, 1983--Afternoon Session

CHAIRMAN VOLCKER. We have an addendum to the minutes from the last meeting, which has been distributed to you. I'm going to ask for approval of the minutes as amended. We do need a motion.

MR. MARTIN. So move.

MR. PARTEE. Second.

CHAIRMAN VOLCKER. Approved, with no objection. You have seen the Report of Examination, I assume. Is somebody here to talk about it or to answer questions?

MR. PARTEE. That's as clean as a whistle.

CHAIRMAN VOLCKER. Do we have any questions about it?

MR. FORRESTAL. Mr. Chairman, I thought I would just ask about that foreign exchange loss. Is that due to intervention or swap agreements or what?

SPEAKER(?). Not intervention.

VICE CHAIRMAN SOLOMON. It's mark-to-market, isn't it?

MR. CROSS. It's due to the change in the value of the dollar relative to these other currencies.

CHAIRMAN VOLCKER. What policy do we follow now? Do we update these every month? Do we mark-to-market every month?

MR. CROSS. We have to update, that's right. So, when the dollar rises relative to the other currencies, in terms of dollars our currency holdings show up as bookkeeping losses not as realized [losses].

CHAIRMAN VOLCKER. We're not permitted to ask questions before we [unintelligible], I suppose.

SPEAKER(?). I beg your pardon?

MR. BLACK. That's a bad omen!

CHAIRMAN VOLCKER. Are there any other questions on it?

MR. PARTEE. Mr. Chairman, with such a clean letter as this, it makes me wonder about the auditors!

CHAIRMAN VOLCKER. It's our own examination people [unintelligible] looking embarrassed.

MR. PARTEE. It seemed to be absolutely clean, though. Would you say that's right, Clyde?

MR. FARNSWORTH. Yes, they were quite clean.

MR. PARTEE. No reservations whatsoever?

MR. FARNSWORTH. Very straight[forward].

MR. PARTEE. Move to accept the report.

CHAIRMAN VOLCKER. It doesn't imply anything about the policy?

MR. PARTEE. No.

CHAIRMAN VOLCKER. Do we have a second?

VICE CHAIRMAN SOLOMON. Second.

CHAIRMAN VOLCKER. In the absence of any objections, it's approved. [The next item on the agenda is] a preliminary report on contemporaneous reserve accounting. Who is introducing this subject? Mr. Axilrod?

MR. AXILROD. I'll say a few words and Mr. Sternlight might also. We really have very little to add, Mr. Chairman, to our eight-page note. The memorandum takes the opportunity to explain how, under present procedures, one would construct paths under contemporaneous reserve accounting and review the paths in the course of the two-week reserve period. The memorandum then goes on to suggest possible additional procedures or alternatives the Committee may wish to consider, which introduce [various] degrees of automaticity to take advantage, so to speak, of the contemporaneous reserve requirements. These, in effect, would let misses in deposits, strong or weak relative to the path, be reflected. In the case of strong deposits we would have somewhat higher borrowings, and in the case of weak deposits somewhat lower borrowings within the reserve period--to some degree automatically, depending on the limits the Committee may wish to set, if indeed it wants to go in that direction. We suggested a couple of rather arbitrary procedures, that the Committee may want to consider, in a somewhat limited effort to get at this under current conditions, where there's some uncertainty about the meaning and the use the Committee may wish to make of M1, the variable to which contemporaneous requirements are tied. I don't know if Mr. Sternlight would like to add a word or two.

MR. STERNLIGHT. Well, I think Steve summarized the note that came from us. But the little that I would add at this point is that we still would have, I assume, nonborrowed reserve targets for each reserve period. I would see those as remaining the central focus of Desk activity. With a two-week rather than a one-week period, our perspective would change somewhat, but I think the main focus would still be on the full reserve period. With a longer settlement period, we would probably give more attention to the profile of excesses or deficiencies within the full period. To some extent, we still would look at weekly reserve levels, but there wouldn't be the same need as now to strive to meet those individual weekly targets. But we probably would want to avoid sizable accumulations of excesses or deficiencies within the two-week span. I don't see any need for different operational techniques from what we work with now.

MR. BOEHNE. Do you have some sense as to how much more variability there might be in the funds rate?

MR. STERNLIGHT. I think it might depend on how one responds to the point that Steve was outlining about the degree of automaticity the Committee may want to permit to occur.

MR. AXILROD. We have two problems to look at. We have a longer reserve period by one week; we have a two-week period. Right now within the reserve period we have some variability, particularly on the last day of the week or before the weekend on special holidays or something like that. What we can't tell is--and we've surveyed a number of banks--[how banks may change] their reserve management procedures under contemporaneous reserve accounting. The answer generally is that they don't plan to change anything they have been doing, and they were doing different things. They're going to estimate their required reserves; I think they're going to be off to a degree. And then they're going to continue doing what they have been doing. Those who tried to play the funds rate within a one-week period are going to continue that and try to play it within a two-week period. And those who wanted to stay in balance day-by-day are going to try to stay in balance day-by-day. With a two-week period there is a greater opportunity to run bigger deficiencies or surpluses in the course of the period. That means there's more they have to make up later. So, it seems to me there is some possibility of a lot more variability in the funds rate within a period if banks happen to allow big deficiencies to pile up and then wait until the 14th day, so to speak, and have to make up twice as much as they previously did. That's one factor. On the average, in a two-week reserve period, our research suggested we missed on our required reserves estimate by $100 million or so, after some revision in the course of the period. And that would have almost an unnoticeable effect, I would suspect, on the average funds rate variability. Of course, if the Committee were to permit a more deliberate miss, that might add a little to it and there could be some more effect. I'm not able to quantify it to any great degree, but I would suspect we would have somewhat more variability within the period and from period to period.

CHAIRMAN VOLCKER. [With regard to] the miss in required reserves that is discovered at the end of the period, to what degree is that related to a change in M1 and to what degree is it related to other factors?

MR. AXILROD. Well, I was thinking of a miss in general when I gave that $100 million figure--$100 to $200 million is what I think I have in here as the [average] miss. I don't have it refined at the moment between what might be so-called multiplier misses on government deposits and interbank deposits and what might be just M1 itself.

CHAIRMAN VOLCKER. Can you say anything sensible about that with further looking?

MR. AXILROD. I think probably with some detailed looking we might be able to break it [down].

CHAIRMAN VOLCKER. That might be worthwhile. Governor Partee.

MR. PARTEE. Am I right, Steve, that this doesn't begin until the first of February?

MR. AXILROD. Yes.

CHAIRMAN VOLCKER. The date it begins is the first of February?

MR. AXILROD. The reserve maintenance period begins Thursday, the 4th and for deposits it's Tuesday, the 2nd of February.

MR. PARTEE. So, we're talking about something that could receive attention again at the next meeting, I think.

CHAIRMAN VOLCKER. Well, we have a little problem here, it seems to me. It occurs to me that we better tell the market what we're doing; we should have a little statement. I don't know how we're going to come up with a statement before the next meeting.

MR. GRAMLEY. One problem I had with the analysis is that it seems to imply that we're looking at M1 as our principal target. What I'm wondering is: What do we do in a world of CRR if we're continuing to target primarily on M2? It seems to me that we ought to have an analysis of that. If we [use M1], we would be changing our operating techniques in that event.

MR. PARTEE. That was going to be my comment, too. This gives us the opportunity for paying more attention to nonborrowed reserves and letting shortfalls and excesses show through. But that does seem to me to require some determination by the Committee as to the amount of emphasis it wants to put on M1. That's why I asked about the timing. It could be deferred somewhat. Also, the figures may be suspect for a while, given the [new] procedures and all that. Peter said we will be setting nonborrowed reserves just as we do now, but my impression is that what we set now is borrowings, not nonborrowed reserves. And if we really did set nonborrowed reserves again, and then contemporaneously it ran off, that would put pressure on the discount window, as was our typical mode of operation when we voted to put in contemporaneous reserves. So, I think it all needs to be considered in that context. I guess I'm doing this as much as anything to remind the Committee that one of the decisions we need to make is the attention to be paid to M1.

MR. BALLES. That's a good point, Chuck. I would ask the question: If we went back to the approximately equal [weight] scenario that we had some years ago, that would not take care of all of the problems we're raising, would it? It might take care of what--half?

MR. PARTEE. I think the proposal, if I understood it from the staff, was that we might start off letting 25 percent of the overshoots and undershoots show through automatically and that might not be too inconsistent with something like equal attention to the set of the aggregates. But perhaps Steve ought to answer that.

MR. AXILROD. In sum, the problem we had in analyzing M2 is that if you are thinking of an automaticity in response, there is none on M2 except to the degree that its M1 component moves. The only required reserves that move contemporaneously, after adjusting for multipliers, are those on M1. So, anything the Committee wants to do with M2--that is if M2 were weak and the Committee wanted to move borrowing or whatever--could be done quite independently of contemporaneous reserve accounting. You wouldn't need contemporaneous reserve accounting to do that. We were trying to think of things that were in some sense uniquely related to contemporaneous reserve accounting. And with a lag we could observe M2 and make whatever adjustments in response to changes in M2 the Committee wished to see made. But the question that arises with contemporaneous reserves is automaticity--letting it happen if we aim at a nonborrowed or total reserve figure. What happens is pretty much purely M1, if we make the proper multiplier adjustments in a contemporaneous way. M2, to the extent it is affected, is only [affected] by M1.

MR. PARTEE. Well, I guess I was reading between the lines.

CHAIRMAN VOLCKER. In a particular week we could make an adjustment for M2.

MR. AXILROD. Sure you can. There's no question about it. My only point was that that wasn't uniquely related to the contemporaneous reserve accounting. That could be done either way.

MR. PARTEE. That's why I thought you suggested 25 percent--to give some weight but not overwhelming weight to M1 behavior.

MR. AXILROD. That's right. And we did have in there at one point a paragraph that I took out about the various things to do if the Committee wanted to put some weight on M2. But that didn't strike me as uniquely related to the contemporaneous reserve accounting. We always have done that.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, if we don't make any more changes in our procedures than Steve and Peter have suggested, I think we're missing a mighty good opportunity on our control mechanism. At least some of us supported this [change to CRR] primarily in the hope that eventually we'd be able to control total reserves better than we could under the lagged system. It's rather painful to me since I had something to do with the lagged system and I hate to see the one contribution I thought I had made go down the drain and turn out not to be a contribution! But in any event, I became persuaded that we could control total reserves better under this system than we could under the lagged system. I recognize, of course, that the two-day lag imposes some of the same problems that we had with the full lag, but not quite as much. And if we deemphasize M1, then certainly we pretty well have to stick to the procedures that Peter and Steve were talking about. But I hope that this is just an initial step toward moving eventually to emphasizing M1. If we assume that the present nonborrowed reserve target procedures are going to be continued under this new regime then, as I think Steve has indicated, with this greater variability in federal funds we ought to be prepared to let that much show through to the extent that [the variability] results from unexpected changes in required reserves stemming from demand-induced changes in M1. That would be a self-correcting brake on whatever might be happening [to M1]. I also think we ought to install as much automaticity in this as we possibly can. Right now, under our present procedures, the Committee is really out of it once it chooses its initial borrowing target unless we have another meeting. And this puts a tremendous burden on you, Mr. Chairman, in deciding the extent to which the borrowing target will be altered. I would greatly favor a more automatic procedure because it would probably operate better. The only alternative is an ad hoc procedure. So, I think the 25 percent is unduly low.

Finally, it seems to me that if the system is going to work very well at all, we have to force the banks to adjust during that part of the reserve maintenance period that overlaps the other period. This would mean that in the last two days of that reserve maintenance period we ought not to let federal funds be subject to overly strict control or else the banks and other depository institutions are not going to adjust during this two-week period at the beginning. If we don't do some of these things, or move in that direction, we really have put the banking system and now the thrift industry through a tremendous amount of pain and suffering for something that's really not going to make us that much better off. We are not only going to have a lot of trouble computing these things but, in my judgment, we're apt to get a lot of errors because it's frightfully complicated. We have to make use of these potential improvements in the mechanism, it seems to me, or else it's all for naught.

CHAIRMAN VOLCKER. Mr. Roberts.

MR. ROBERTS. It has been my assumption that the purpose of contemporaneous reserves, which have involved an enormous effort to put in place, is to improve control over the aggregates, particularly M1. I don't want to repeat what President Black said; I'd like to associate myself entirely with his views. I concur with him.

I was going to ask the question, Steve: If the purpose is better control of the money supply, wouldn't we be better off targeting on total reserves? I think we should [exercise] reduced flexibility rather than the other way around. The only problem that I can see from that is increased volatility of interest rates, which I think the market would adjust to readily.

MR. AXILROD. Well, if we had every multiplier adjustment right, that would probably be the case. We don't normally get the mix even in money supply type deposits--those at small banks and those at large banks--exactly right. So, that tends to throw us off.

MR. ROBERTS. The multiplier differences are generally very short term, though, aren't they?

MR. AXILROD. Yes, that's right; they might average through. But on the technical side, the study we did a couple of years ago--before we had contemporaneous reserves, but even after we tried to allow for it--seemed to suggest, surprisingly, that nonborrowed reserves were probably better in controlling M1 on a month-by-month basis than total reserves so long as we didn't have exactly the same reserve requirement on all types of demand deposits. We have reduced those variabilities. We only have three classes now: zero, a small one, and a large one. Still, I would suggest that you would be surprised that total reserves would [not] do quite as well as you think it would.

MR. ROBERTS. I'm thinking about our target in recent months and our actual experience and wondering about our control.

MR. BLACK. Steve, this gets closely at the point that Chairman Volcker was raising a while ago. Two kinds of demand deposits are in there that are [not] normally in M1: government deposits and interbank deposits. I would think one could pretty well estimate what they are going to do over an extended period of time; at least what little work I've done on it suggests that. Insofar as shifts between large banks and small banks [are concerned], yes, in the short run that is important; but over the long run I wouldn't think that really messes us up very much. The whole thing has been designed--at least I've perceived it this way and I'm sure others have also or it wouldn't have [been adopted]--to control M1 because, as you mentioned, that's the only aggregate that is subject to contemporaneous reserve requirements. All the rest, M2 and M3, are subject to lagged reserves. So, we go into a reserve period and supply what reserves are needed against those liabilities that have been lagged. Then we put in an additional amount to take care of the interbank and government deposits plus what we think is necessary to achieve the right expansion in M1. I believe that's manageable, although, of course, we have to agree that we want to control M1 before we can do that.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. Well, it seems to me that we ought not to use the existence of CRR as a reason to go to M1 or not to go to M1. We ought to give more or less weight to M1 depending on our judgment as to how good an intermediate target it is. CRR is a means to an end; it seems to me that we have the argument backwards when we say we ought to put [more weight on] M1 because we now have CRR. There is probably a case to treat M1 on the same footing as M2 and M3--not that M1 is particularly good, but it's not a whole lot worse than the other two. So, I think there is a case to give it equal weight. If we give it nearly equal weight or equal weight, there is a case for some degree of automaticity, and it strikes me that something like 25 percent is not a bad way to start. It's a reasonable blend with which to begin to experiment. But the main point is that we ought to judge M1 on its merits; I don't think whether we have CRR or not is a reason pro or con to give additional weight to M1.

MR. BLACK. If you thought that was my [predilection], Ed, I misled you.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. It seems to me, as has already been said around the table, that if we really are going to implement CRR and make it meaningful, we have to elevate M1 to the essential, intermediate target we follow. I have two comments about that: First, I do not believe the informational content in M1 relative to income is sufficient that I would be prepared to do that; and secondly, we're moving into a period where the commercial banks are learning how to operate under contemporaneous reserves and that uncertainty would suggest that at least for some period of time--maybe as much as six months--we would want to continue to operate very much as we have in the past. We may want to run an experiment along the side to see what would happen if we adjusted 25 or 50 percent. But I would not run policy in the upcoming period--at least until July--given the uncertainty that falls out of CRR and the uncertainty that falls out of the relationship of M1 to the real economy. As a result, I would propose that we not change operating procedures until we get a good deal more experience than what we will have on February 2.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. Well, I was not terribly sympathetic with the procedures we followed from October '79 to October '82 in the first place and I haven't looked back on that period with any different view. I'm even more reluctant to see us go in that direction now by elevating M1 even partially toward an intermediate target or by increasing automaticity. That's not just a matter of week-to-week or day-to-day or even month-to-month variability in the funds rate that we would be looking at, but it's the fact that we're looking at relationships between M1 and GNP since the fourth quarter of 1981 that simply have no parallel in prior history. To make it very simple, let me take the past several months. The staff has been anticipating a substantial increase in the growth rate of M1, as I have, because we have such a strong economy. It hasn't happened. If we had had the kind of operating techniques that we did earlier and they were augmented by CRR, we would have experienced in the past couple of months a very substantial decline in interest rates. And from my reading of the economy, we need a decline in interest rates and a stimulus to economy activity to go with the fiscal stimulus like we need holes in our heads. In my judgment, we're looking at a very strong economy--an economy in which the risks are too much expansion, rather than too little, and more inflationary pressures. I recognize that not everybody agrees with that, but that's my view. And that's why I would be very, very reluctant to see us go back to an automatic response pattern and the use of M1 as an intermediate target now.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. There has been some change, at least in my thinking, and I think in the broader perception, of the desirability of very tight money control since we adopted CRR. We went to CRR, I think, in order to achieve this tighter control of the aggregates; we've seen that it can miscarry. I have become more concerned about wide fluctuations in interest rates and, therefore, more concerned about the possible consequences of a rigorous application of contemporaneous reserve requirements on an M1 basis and on a fully automatic basis. We made this decision and I think we have to move somewhat in that direction. Also, I don't think we can be quite as relaxed about M1 as we had a right to be while it was misbehaving. I think it is beginning to establish somewhat greater credibility but it's certainly still under some degree of suspicion. So, since CRR does point toward M1, with the relevant reserves that are contemporaneous being for the most part against M1, I think we can't avoid giving more weight, though perhaps not full weight, to M1. I think some automaticity is desirable because that's the nature of the whole operation. If we didn't have automaticity, why have any form of contemporaneous or lagged reserve control? But I would not make it total; something in the range that has been suggested by the staff strikes me as a reasonable compromise.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. Well, as almost everybody knows, I was never persuaded by the case for CRR to begin with and I'm still not. I never thought it would make that much difference in terms of how well we could control M1 even if we decided that we wanted to control M1 and nothing else. I do agree with Mr. Boehne's point, however, that the logically prior decision here is what we want to do with M1. But quite apart from that, I must say that my hunch is that we're going to end up with more [interest rate] variability than Steve and Peter seem to expect. That's just my hunch; I can't prove it either, but I think that's the way things are going to go--that we're going to have more noise and little or no improvement in the control of M1. So, if I really had my druthers, I'd drop the whole thing. But I don't think we can do that. I think it does argue, though, for what I would call a "go slow approach," particularly for the first few months. I have always liked a degree of automaticity but I would be willing to compromise that in the interest of trying to get this in place in an orderly way. I suspect that the full impact on data flows and on the operations of cash managers of big banks and small banks has not been fully digested in spite of the enormous amount of work that has been going on around the Federal Reserve in trying to get people up to speed on this. In short, I don't think the operational impact either on us or on the banks has been fully digested up to this point. That again would argue, in my way of thinking, for a go slow approach. As far as our own operations are concerned, I must say that I did not walk away from reading the memo with a great deal of confidence that we know what we should do ourselves, much less that we know how the banks will respond to what we do. Maybe I missed something but the bottom line is that I'm distinctly uneasy about the whole thing.

MR. AXILROD. We were pained, Mr. Corrigan, to leave options for the Committee and not make a recommendation that would sound as if we were certain about how we're going to approach it.

MR. CORRIGAN. Well, I'm not thinking so much of your 25 percent [suggestion] in there. I'm just thinking of what lies behind all that. This question of whether we have a miss because of what you call multipliers as opposed to a shift in money demand is a profoundly important question. Which side of that coin one is on [is important] even on a week-to-week basis. It seems to me that it's going to have very, very sizable implications for the amount of noise in the money market.

MR. AXILROD. Mr. Chairman, there is one thing--

CHAIRMAN VOLCKER. Are you going to give us a little analysis of it?

MR. AXILROD. Yes, but I thought in the context of this discussion that there is one thing that perhaps is not clear enough [about] the automaticity in response to M1. For example, if M1 were weak by an amount that said borrowing would drop, say, $50 million in that week, we did not necessarily concede that the next week we would start off at a lower level of borrowing. That would be a matter of decision for the Committee. So, for example, if M1 were weak and M2 were on track or strong, with any automaticity in there, borrowing might be $50 million [lower one] week but the next week we could start off with borrowing where it was earlier.

CHAIRMAN VOLCKER. We always come within $50 million anyway!

MR. AXILROD. That's right! And the next week if M1 were strong, borrowing would be up $50 million and it could fluctuate; we wouldn't make judgmental adjustments of borrowing unless the whole bunch of the aggregates seemed weak or strong relative to the Committee's anticipation or whatever rule the Committee might want to use.

MR. PARTEE. When you say $50 million, where do you start off--where you were before? I don't quite understand.

MR. AXILROD. Well, suppose we started off a week at $650 million, as we have been doing, and we got all the multipliers correct and all that and by the time we were through the two-week period, M1 in fact was weak to the extent that borrowing dropped $50 million and ended up at $600 million. Then the question comes up: What level of borrowing do we start the next week with? I'm saying, unless the Committee says otherwise, we would start at $650 million again and then if M1 is strong that makes up for that and we would be up to $700 million of borrowing.

CHAIRMAN VOLCKER. To put it in perspective: $50 million would imply a $500 million dollar weakness in M1 from where we were, roughly.

MR. PARTEE. I guess I would have thought if we had let borrowing drift down from $650 to $600 million because of a weakness in M1 one week, that if M1 were then strong the next week, thus offsetting the [previous weakness], we'd drift back to $650 million from $600 million. It seems we might get a progressive movement if we always went back to where we thought we should have been.

MR. AXILROD. Well, that's [an issue] we are raising. The Committee can decide whether it wants to cumulate, which would be to go up to $650 million [in this example] or stay at the $600 million as the way to take account of M2 and M3 and everything else.

CHAIRMAN VOLCKER. If we had a week in which M1, according to our perfect seasonal, went up by $5 billion--if you could imagine a week of that sort--when we were thinking it was going to go up $1 billion, borrowing would go up by $400 million, all that being perfectly arranged.

MR. AXILROD. If we took the full 100 percent; at 25 percent we'd be better off.

CHAIRMAN VOLCKER. I don't quite understand this taking a 100 percent or 50 percent. You're not going to know what the figure is; you don't know what to take 50 percent of.

MR. AXILROD. We have our estimates. You're right that there is always going to be the noise from the errors in the estimate.

MR. MORRIS. Well, Mr. Chairman, I agree with the statements of Governor Gramley. I opposed moving to contemporaneous reserve accounting on the grounds that it didn't make sense unless one believed that M1 was a sensible target for policy. But now that we've made this investment, I think we ought to look upon it as a sunk cost and as something that we will have in place in the event we ever seriously want to go to pursuing M1 again. I don't think the fact that we've made this investment should automatically push us into changing the way we're currently running monetary policy. I agree with Lyle: I think it would have been a big mistake if we had had this in place 6 months ago and had pursued a much more aggressively easy policy, which we would have had to do. I don't think we can substitute this new system, in this context, for the good judgment we have been using.

CHAIRMAN VOLCKER. Well, I think it is analytically correct that we went out and bought a potato digger but we don't have to plant the potatoes.

MR. PARTEE. We can plant them; we don't have to water them.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Well, it seems to me that CRR more than implies a higher level of control of the aggregates and, whether we like it or not, it's going to be with us on February 1st. There has been an enormous effort expended by us and by the commercial banks. And I would hope that for all of this trial and tribulation and money we'd be able to deliver something. It seems to me that all this does imply a much greater emphasis on M1 than we have been giving it recently. We have been through a period of significant adjustment; I think we would be making a mistake if we did not use this as an opportunity to move to reemphasize M1. I would in no way suggest that we ought to put the system on automatic but I wouldn't lose the opportunity. I'd begin to reemphasize M1 as our principal aggregate. I would plant the potato.

CHAIRMAN VOLCKER. You're going to plant a small field! Mrs. Teeters.

MS. TEETERS. As you well know, I objected to CRR all the way along and I associate myself with reservations about M1 as a major target in policy and about its relevance to GNP. But I'm more concerned that if we go to any degree of automaticity, we're going to get increasing volatility in the interest rates. Can you give us some estimates, Steve? If we go to 10, 20, 25, or 50 percent automaticity, what degree of volatility will we reintroduce into the interest rate structure?

MR. AXILROD. Well, Governor Teeters, our best guess has always been, that we get 20 to 25 basis points per 100. It seems a little less.

MS. TEETERS. Per 100 of what?

MR. AXILROD. A hundred million dollars of borrowing. We thought [a change of] something like $400 to $500 million in borrowing would result in a one percentage point [change in interest rates].

Now, we've gone through $400 to $500 million of borrowing with virtually no movement in the funds rate in the process of which we've declared that there were shifts in the demand for borrowing, shifts in the demand for excess reserves. And making those judgments has tended in some sense to moderate these movements, or the banks have just not cared. We haven't gotten those kinds of movements. So, I would not really want to swear on a stack of Bibles that a $500 million borrowing change will give you 1 percentage point. But I would say that with a $50 million change in borrowing within a week one is not going to discern the effects relative to the noise. It has to accumulate to begin to move the funds rate in some sort of trend way.

MS. TEETERS. Well, what are you referring to as "noise"? I was interpreting that as being volatility in the interest rates.

MR. AXILROD. I meant the variation [at the end of a statement period.] Mr. Sternlight aims at a nonborrowed reserve path constructed from some borrowing assumption and some knowledge of the demand for excess reserves. The noise that I meant was what happens to it on the last day of the statement week when the factors affecting reserves other than his actions vary by $2 billion, say, or when required reserves relative to expectations change by a lot.

CHAIRMAN VOLCKER. For reasons other than a change in M1.

MR. AXILROD. Yes, and changes that we hadn't allowed for; we were estimating but we missed. And that will either add to that $2 billion or subtract from it; they could be offsetting. To the degree that it adds, there is going to be a result in the relation in free reserves or nonborrowed--they are the same--that is different from what we were aiming at. That's a kind of noise in the system, I would say. The additional noise is how banks decide to manage their reserves over a two-week period. If they suddenly get it into their heads that the funds rate is going down when it isn't, they are going to get themselves into a deep hole and at the end of the statement week they are going to have to borrow a lot. Over a 14-day period they might have to borrow, instead of $3 billion on the [last] day, $6 or $7 billion. That will put a lot more pressure on the funds rate than they have been used to. So, over a two-week period there is a little more capacity for noise, depending on how banks manage their reserves and what [rate] expectations they have for one reason or another.

MR. ROBERTS. Even banks learn!

SPEAKER(?). Over time.

CHAIRMAN VOLCKER. More slowly than most other people!

MS. TEETERS. Well, I think one of the great costs of the period from '79 to '82 was the high volatility of rates--not only the short-term rates but the long-term rates. What I'm really concerned about is that I simply don't want to get back into a situation in which that sort of volatility reoccurs.

MR. AXILROD. I didn't mean that as "noise". I meant what seems to me to be the product of the controls of--

MS. TEETERS. But the more automaticity we build into the system, the greater the volatility is going to be.

CHAIRMAN VOLCKER. We're almost bound to get more volatility in the very short run, whatever we build into this. I think--we'll see--that just [the nature of] this system is going to give us more very short-run volatility.

MR. AXILROD. Probably.

MS. TEETERS. But one of the things that was most damaging was that the short-term volatility got translated into the long-term market.

CHAIRMAN VOLCKER. It probably happened over a longer period of time--volatility over a month, two months. I'm not sure. That's an open question. But I think within a two-week period we're going to get more.

VICE CHAIRMAN SOLOMON. Unless we offset it.

MS. TEETERS. Unless we offset it.

MR. BLACK. We should get more variation in the federal funds rate concomitant with that. If we hit our target on a more regular basis, I wonder if we'd really have that much volatility in other short-term rates. I can see very easily that we would in the federal funds rate. And I'm not sure it follows in longer-term rates.

MR. GRAMLEY. That was the argument that was used in October '79: You don't have to worry much because most of the variation would be in the funds rate, a little in the short-term market rates, but the long rates would hardly react--particularly after the markets have an opportunity to adjust. And that just didn't happen at all.

MR. BLACK. But we didn't hit our targets as regularly as I am talking about.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Well, Mr. Chairman, I'm one of those who never really understood completely how CRR was going to give us more precision with respect to the monetary aggregates. But that's water over the dam, as other people have said, and I think we have to go forward with the program. But I think there's going to be an awful lot of confusion out there right up until February 1st, particularly among the smaller and medium-size banks. That confusion is going to reign supreme for some weeks after we introduce this system. So, I don't think we ought to go in any way to any automaticity at this point. I would much prefer to see us go slowly. Automaticity has a certain amount of logical appeal, but I think the timing is wrong in terms of the implementation of CRR. The other point that I really would like to make--and perhaps this also has been said--is that I don't think we ought to be looking at the question of CRR's relationship to M1. The question ought to be asked the other way around. The threshold question it seems to me is: What target does the Committee really want to focus on? We ought not to be pushed into one or the other because of a technical accounting system. And I happen to think at this point in my membership on this Committee that M1 is a pretty good target and one that has a pretty good relationship to GNP. Others have argued that around the table before. But it's a question that we now have an opportunity to look at in great depth and I think we ought to seize the opportunity before CRR becomes effective to zero in on what we really want to target on.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. I guess I'll resist the temptation of asking, Mr. Chairman, why we decided to go back to CRR in view of all of this. But passing beyond that, first I'd like to associate myself with the view that Ed Boehne expressed so well: Just because we have CRR doesn't mean we necessarily should revert to M1 as the primary intermediate target. However, I consider it personally a rather fortunate piece of timing in that I'm convinced--as some others are around the table, though many are not--that we are in the process of witnessing a new behavior of M1 where it's going to be more reliable. We're beyond that stage where velocity dropped in that unprecedented manner in '82 or early '83 and, therefore, we now can begin to rely more on M1, as we used to do. If that's the case, and it happens that it has come along just at a time when we could have some automaticity in M1--not complete in my view--then some automaticity would not be damaging; it probably would be desirable. I wouldn't want, as Si Keehn said--I think it was you, Si--to go fully automatic. But I think it's time we went partly that way. I come out, bottom line, in much the same way as Si Keehn and Ted Roberts and Bob Black did.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. Mr. Chairman, I join those of our colleagues who have been accepting the hypothesis that we will have more volatility in short-term rates, perhaps spilling over into long-term rates, by a closer adherence to M1 targeting, or by CRR. And if indeed there is to be some degree of increased volatility as a result of our moving in that direction, it seems to me that the risks in 1984 and in 1985 should be kept in mind and would mitigate against our moving in that direction. I'm thinking, of course, of the international debt situation, of the efficacy of business fixed investment as a sustaining force in the expansion, of housing, and obviously of commercial construction, which I think is going to be the next REIT disaster and which is susceptible to the influence of [interest] rates. It seems to me that there is some potential reward, but it's rather a paper reward, of controlling M1 better. But how long is it going to take us to learn what velocity is going to be and what trend line is going to emerge--either the old one or a new one? How long is it going to be before we can see what the relationship of this new one is with regard to the economy? I think we may, as a group, have a more favorable look at M1 and at a more automatic procedure later. I am sure that many in the markets will continue to feel, surmise, believe in, or have faith in M1 and its close relationship with economic activity. As long as that belief is out there, it's something we have to deal with. But now with the unknowns with regard to velocity and M1 and the risks to this economy by increasing the volatility of interest rates, I simply think we should wait.

CHAIRMAN VOLCKER. Well, let me draw several conclusions. I think it is logically or otherwise correct that simply because we adopted contemporaneous reserve requirements, for better or for worse, we don't have to arrange our policy from now until eternity to take maximum advantage of that operationally. That's a separate decision and logically comes first. Secondly, I do have the sense that there's enough uncertainty about this [CRR] that we're not going to want to do anything very radical in the very first months of its introduction. There may be very little change. Thirdly, I think we really have to say whether we're going to do anything very different or what we're going to do because there will be [a lot of] confusion around. And if this process begins on February 2nd, inevitably I guess we're going to have to say something before then.

As a footnote, I want to be reminded that we may have to advance the next meeting, anyway--which will be convenient for this reason, I suppose--because I might have to testify before the Lincoln Day recess in the Congress. If so, that doesn't give us enough time [between] the meeting as it is now scheduled [and] the testimony. I don't know that for certain at the moment, but we may have to get back with you to see about a date roughly a week earlier [than now scheduled]. If we do that, we can then decide precisely what we want to say, although even then it will be getting kind of late, I suppose. It might be that there will be a lot of questions. I would prepare at least one version or maybe two or three versions of precisely what an announcement might say as to how we're going to handle this at least for some transitional period while we at least make sure that the statistics come in in an orderly and predictable way.

Then, finally, I think the question is: What weight do we want to put on the different aggregates, which is the natural subject of the discussion at the next meeting in terms of setting targets; we're going to have to discuss it anyway. People probably have different opinions about whether we will want to make any major changes, but it is a natural focus of the discussion. But even if we put a lot of weight on M1, I wouldn't be prepared to put full weight on it for at least a brief transitional period to gin up an operating [procedure] just because we have contemporaneous reserves, simply to get the operating bugs out at the extreme.

MR. ROBERTS. Mr. Chairman, I agree with you on that entirely, but I think we've left unsaid here one point that is important. And that is: In this interim high-risk period of 6 months we've built very wide latitudes on reserve requirements and we've essentially made the smaller banks immune to the process, which I think reduces the risk. It doesn't eliminate it, but it certainly reduces it.

CHAIRMAN VOLCKER. Well, we'll see how it goes. I don't have a good feel for it. On M1 itself, just to make one substantive point, I have some feeling that it's getting a little better but I don't know why. It has been way off on the low side, and seeing it come back from that I guess makes everybody feel a lot more comfortable. But we have one quarter of an exceptionally large rise in velocity now. So, while I have a feeling that maybe it is going to be reacting a little more normally, we surely can't prove it by any figure we've seen at any particular point in the past quarter anyway.

MR. MORRIS. I think M1 is a random walk.

CHAIRMAN VOLCKER. Well, I'm not quite willing to say that.

MR. BOEHNE. I'm surprised to hear you say that, Frank!

CHAIRMAN VOLCKER. I'd hate to have to pick out today what the trend is going to be over the next three years, even though I have the feeling that it may be a little more reliable. I'll know more three years from now. Well, is there anything else to be said on this subject?

We will see once we set the date of the next meeting, but we may either have to circulate something to you in writing before then or have a telephone call or something because I do have the suspicion that people in the market and everybody else are going to ask what this is going to do and how we are going to conduct ourselves. They will ask whether we are going to do something radically different and we ought to tell them.

MR. BLACK. Mr. Chairman, could I make one more observation? On this automatic part, suppose we've agreed that M1 deserves a little more emphasis than it now has; if it runs above target and consequently required reserves are higher than the path, we can either adjust the borrowing up automatically or we can do it on an ad hoc basis. Since we've not been emphasizing M1 to any great degree, these adjustments in the borrowed reserve targets have all been on an ad hoc basis. There's no way the Committee can realistically participate in those decisions. That has to be left up to you in consultation with Steve and Peter or however you want to do it. And that is the point: That is the only alternative to some kind of automatic adjustment mechanism, if in fact we're going to pay any attention at all to M1. I think we ought to focus on that part of it. I'm quite willing to delegate that to you, but I'm not sure whether I'd be that willing to delegate it to your successor, whoever he might be.

CHAIRMAN VOLCKER. On this M1 issue, I don't know what the figures look like, but I was looking at this so-called experimental seasonal, for what it's worth, that we publish figures on. The monthly figures look quite different.

MR. AXILROD. We publish them weekly. Yes, [they look different]. In terms of absolute variations, though, be aware that the average absolute variation of the experimental, both monthly and weekly, is just about equal to the average absolute variation of the regular series.

CHAIRMAN VOLCKER. They look erratic in different ways.

MR. AXILROD. That's right.

CHAIRMAN VOLCKER. That's the way I see it.

MR. AXILROD. Very different [timing].

MR. ROBERTS. We don't get growth in December on this experimental [version].

CHAIRMAN VOLCKER. No, and it shows a sizable growth in November, I think. That brings it to--

MR. AXILROD. And the weekly changes in the experimental series are sometimes larger than in the regular series.

MR. ROBERTS. The seasonals wouldn't affect the reserve requirements, would they?

CHAIRMAN VOLCKER. Yes, because the target is set forth in seasonally adjusted figures. We live in an eerie world of seasonal adjustment, but when they are converted into--

MR. ROBERTS. They're real, but they're converted--

CHAIRMAN VOLCKER. Yes, but they're converted from a target that is seasonally adjusted.

MR. BLACK. Mr. Chairman, could I ask Steve about that point? Steve, what do you think about the merits of the experimental [seasonal] versus the regular one? We've done some work that suggests that the seasonals are probably bad for the last part [of the year]. Hence, we didn't have as much of a burst in M1 earlier and we haven't had as much of a slowdown since then. What one believes on that makes a lot of difference, I think, in where one comes out.

MR. AXILROD. Well, my memory is that if you look at the two series on a quarterly basis, the pattern doesn't look very different. There are small differences, but not big ones. There is somewhat slower growth, I think, in the experimental [series]. I'm not sure of this in the second half, quarter-over-quarter. But month-to-month, if you look at the second half, the growth rate in the experimental series drops somewhere around July--I may be off by a month--and then with the exception of one negative month where it's -0.5 percent, it fluctuates between 3 and 7 percent. So, it tends to look as if it has dropped down to a new 5 percent or so growth rate.

CHAIRMAN VOLCKER. Yes, it looks much more like a drop to a plateau than--

MR. AXILROD. Whereas the other series looks like it was going along strongly and suddenly it dropped to 2 or 3 percent for four months. It gives a slightly different look to M1. Up to that point I had been getting prepared to recommend to the Board that we drop the experimental series, mainly because it wasn't showing any less volatility. I had the feeling, therefore, that it was just proving that weekly and monthly seasonals are difficult to get at and that M1 is an inherently volatile series. That's how I would interpret M1. But now it looks as if the experimental series has made a comeback. It seems to me that it still has some value and I would tend to recommend that it be continued, but certainly only experimentally. It hasn't demonstrated--and we haven't found--a way to make the weekly seasonal variation less.

CHAIRMAN VOLCKER. The only thing I conclude from it is that, as Steve is suggesting, weekly and monthly seasonals are very treacherous and we shouldn't assume too much. But [the results] are quite different, depending on which seasonal one uses.

MS. TEETERS. Well, that argues even more strongly against any large degree of automaticity. If our current data are highly volatile, we don't quite know where we are.

CHAIRMAN VOLCKER. Well, we're back in that old dilemma: If we wait too long, we've waited too long; and if we react too quickly, we've reacted too quickly.

MR. BLACK. It's hard to argue with that one!

MR. AXILROD. As a technical point, Mr. Chairman, a two-week reserve period has the advantage of averaging through a little, in some sense; it has the disadvantage of delaying [us] ever so slightly.

CHAIRMAN VOLCKER. Is there anything else to be said on this subject? We will turn to Mr. Kichline.

MR. KICHLINE. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Okay. We can have some Committee discussion, which I would hope would focus as much as possible on what risks, probabilities, or otherwise, people may see looking out 6 to 12 months ahead either on economic activity or on prices. Mr. Boehne.

MR. BOEHNE. I think if I were sitting where Jim is sitting, I would probably come up with about the same forecast, but I suspect that the economy is going to turn out to be a good bit stronger next year than the standard forecast. I think that what we have here is a cumulative self-feeding momentum that will deliver a stronger economy so that the total, in effect, is stronger than seemingly the individual parts. I've talked to a lot of people from a lot of different industries in my District in recent weeks and I think terms like euphoric and ebullient and buoyant are very descriptive [of their views]. If I heard these kinds of reports from my good friend Bob Boykin I would say: "Well, that's Texas." But when I hear them in Pennsylvania and around the Third District, which has generally been on the slow side, that tells me something about what is happening to this self-feeding momentum and to the psychology. My board, which generally has been on the bearish side--we have some industries that have been hit fairly hard--in its meeting last week was concerned for the first time in memory that perhaps things were moving along too quickly to be sustainable.

Now, having said that on that side, I also think the risk of more inflation is greater. I think that's definitely where the risks are and also that we likely will get a stronger economy. Also, I find a great sensitivity to interest rates out there--a view that [higher] interest rates could shut this down fairly promptly. For what it's worth, I have the sense that if interest rates went up 1 percentage point or so, it probably would dash some of these expectations but not a great deal; but if the increase were in the 1 to 2 point range, I feel it really would have a major effect on this psychology. A good many people I talked to think that if we had something in the neighborhood of a 2 percentage point increase in rates, that could reverse things fairly quickly. I'm not saying that that is scientific fact or even that it is true; I'm simply giving you a sense of how people view various kinds of increases in rates.

CHAIRMAN VOLCKER. You're not going to tell us whether you agree with that?

MR. BOEHNE. Well, getting ahead of ourselves, I think there is room for a little snugging but it ought to be very cautious--just enough to deflate the bubble a little but not all that much.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. I didn't know I had put my hand up, but I'll go ahead anyway. I put my comments in two categories. First, for the past couple of days I have had in the Bank the CEOs--and strictly the CEOs--of a good cross section of major industrial companies in the Ninth District, including some of the really Blue Chip companies up in the Minnesota area. I have been getting from these people almost astonishing reports of very pronounced stretch-outs in deliveries that have materialized just in the past six months. One of the big computer manufacturers, for example, said that six months ago he could pick up the phone and get anything he wanted just like that. Now, six months later, he's looking at delivery delays of six months to a year on things that were simply available with a phone call a few months ago. There were reports of very, very strong final sales. And this seemed to be the case across the board, in everything from wood, construction materials, soft goods, computers--you name it. One of the very substantial food companies indicated that their soft goods operations--not the foods in some cases--were showing unit sales in December up 40 percent from a year ago. There was a--

CHAIRMAN VOLCKER. What company was that?

MR. CORRIGAN. It was Some of their soft goods-- and things like that were up 40 percent in unit terms.

MR. PARTEE. Their sales to retailers?

MR. CORRIGAN. They own the retail outlets in some cases, so it's a mix of both their own retail outlets and their supplies to retailers. I think it's fair to say that in one way or another every one of these CEOs reported building price pressures. The good news is that they all at least indicated that they were holding the line on their wage cost [increases] for 1984--other than a bank, which wouldn't surprise you. Other than a bank, every one of these roughly twenty or so firms reported that their plans were for compensation in 1984 [to rise by] 4 to 5 percent or less. They also reported, again almost without exception, very severely depleted inventories either in their raw materials or, in the case of those in retailing, in items on the shelves. Perhaps most disturbing of all to me: There was a truly universal expectation among these people that we would have sharply higher inflation and interest rates by the end of 1984. Believe it or not, some of these people even spoke in terms of a "buy now" attitude creeping back into the picture for fear of the outlook toward the end of 1984. That was my rather clear impression, with the exception of the wage side, which would suggest that the risks for both the economy and inflation are very much on the up side. There was deep concern, even among the people in this group whom I know to be very close to the current Administration, that the deficit situation is totally out of control--that there is no prospect whatsoever for being able to deal with it in the near term or the long term. Again, at least among this group, there was a sense that it was just very, very [important] that the Federal Reserve do what it could to hold the line.

Abstracting from those comments, I still obviously feel personally that the risks are on the up side in the economy. We know exports are a soft spot and there certainly is, I think, more financial vulnerability out there than meets the eye. I don't think that problem is behind us by any means. But the thing that gives me the greatest cause for concern right now is that I can't quite figure out for myself what really is happening with inflation. In the last six months the rate of increase in the consumer price index has doubled--more than doubled. It is now running at 5 percent or a little better, and I can't see that there is any great influence of special factors in there. Maybe Mr. Kichline knows something that I don't know, but I can't find them. I don't think that the markets in general have quite caught up with the fact that the consumer price index now seems to be rising at a rate of 5 percent or a little more. On the other side, we haven't seen any pickup in the deflator; and certainly wholesale prices continue to look very good. One of the things that I look at myself as a barometer of price pressures is the spread between the rise in the GNP deflator and the behavior of unit labor costs in the economy as a whole. Very seldom does that spread exceed 2 percent and it's unprecedented for it to exceed 2 percent in the early stages of the recovery. But we're looking at a spread of something like 3-1/2 percent, which I would interpret as a great desire on the part of businesses to make themselves whole from the recession or to get themselves whole [before] the recession they think is going to come in 1985. The bottom line, from my perspective, is that we may already be seeing a build-up in price pressures in the economy that if carried forward in 1984 would be very, very disturbing. That's about what I think, Mr. Chairman.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Mr. Chairman, as far as the Board staff's forecast, we would not have a whole lot of difference in views. In terms of the risk: If it's wrong, it's probably a bit wrong on the down side; I think the economy is possibly a little stronger than the staff has indicated. I'm hearing much of what Jerry is hearing; there does seem to be a real concern about the possibility of inflation reaccelerating if the pressures are not already there. Looking at it from our part of the country, it still is a bit of a mixed bag. We are getting strength now from some of the areas that had been slow coming back [from the recession]. Of course, housing has been one of the strong factors [in the expansion] and that is levelling off. And that is a good sign because I think we had gotten ourselves into an overbuilt and risky situation in terms of the land boom. I know this has been commented on before, but it is still is going on. The newspaper has been running a series of articles on what is apparently a real scandal involving condominiums. [Developers] built over 5,000 condominiums in just one little area out by a lake but increased [prices] 600 percent in one day through land clipping. They are selling the condominiums at a rate of 42 units a month, so they have a 6- or 7-year supply. The small savings and loans around the state have been drawn into this. They are very exposed; even the good operators--or those who were supposed to be good--seem to be caught up in it. The president of a title company told me--and he sees a lot of these deals in north Dallas--that he bought a piece of property for $17 million. He was going to close on it a week ago last Friday. Before he closed, he sold it for $34 million and that transaction was closed last Friday. I don't know what somebody sees in it that the seller wasn't seeing!

On the energy side, drilling in particular is showing a little strength. In the natural gas area, which has been quite a problem, there is some feeling that the bubble is about to [burst] and that maybe by late '84 that will have leveled out a bit. On the agricultural side, by the time one puts together the pluses and minuses it turns out to be a little better than was anticipated. Again, though, it's pretty uneven if you look at our District as a whole. Northern Louisiana and New Mexico are showing a little improvement; it's still rather tough out there. On the unemployment situation, we're below the national rate, but the state of Texas as a whole has an unemployment rate of 7.4 percent while for Dallas/Fort Worth it's 4-1/2 percent and going down. So, my bottom line would be that there is some strength and that we are seeing some sectors beginning to come back that are taking up the decline. In housing, we are anticipating that the financial side will be a concern; of course, our banks and other major institutions are not reporting very good results for the fourth quarter and they are making rather substantial loan loss provisions for 1984. There is a lot of concern that 1984 is going to be a bit hard, primarily [because of concern] that the turnaround in energy will not occur before the operators, the service companies, and so forth are going to have to [unintelligible].

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. Mr. Chairman, you asked for comments with regard to some of the downside risk aspects of the economy. Let me mention two or three, beginning with the projections we have with regard to commercial property development in the fixed investment sector. President Boykin mentioned the speculation in land. I want to take that one step further into the commercial property area where the so-called syndications-- companies and others have sales of $50 million, $100 million, $200 million at a time--have bid up the prices of commercial property and brought on to submarket after submarket a supply of this kind of space, which is having its effect on the existing commercial properties in those submarkets. I believe that the IRS review of so-called tax sheltered investments, if it results in any kind of substantial change in the tax position of these investors in the syndicates, particularly these privately offered limited partnerships, could result in a very substantial contraction of ownership of commercial property and development--the mortgages thereon--in this country. And I think we're headed for a very substantial setback there.

As far as housing is concerned, I have never seen in my experience with mortgage portfolios over more years than I would like to admit the poor quality that one sees in mortgage portfolios today--if we subject them to any kind of analysis. The builders who have gotten people into these mortgage arrangements and who now have withdrawn their subsidies--their so-called buydown arrangements--have left a situation in which the value, if I may use that term, of residential property is no longer rising despite what we see in scattered statistics. And, therefore, the position of those households as far as payors are concerned is under severe pressure. So, the losses that the private mortgage insurance companies are taking continue to go [up]; the quality of the residential mortgage portfolio has deteriorated; and there are further losses out there in the future with regard to these situations.

In terms of inventory, I had the opportunity recently, as did President Corrigan, to spend some time with business people--retailers in several parts of the country. I take it, Jerry, that you were talking about manufacturers in the big companies. But the information I got at the retail level--here I'm shifting from comments on risk to comments regarding inflation--is that particularly because of the availability of overseas sources for the retailers, so far they have not faced the kind of price pressures that you indicated in other segments of the private sector. Quite the contrary, at this stage of the recovery they find that they can get to sources [of supply] and they don't have to maintain a heavy inventory and have no plans to maintain a heavy inventory. So, once the Christmas selling season is over, they will have some bare shelves. But some of them are willing to trade off at the margin what they consider minor market share losses for the rigid control of their inventory. On the plus side, what I have picked up on these matters has been an emphasis on productivity--the profitability, say, of the auto companies in the Midwest. They are looking toward break-even points at much much lower levels than before, in part because they have taken out of their costs--as they express it--several billions of dollars.

So, it seems to me that we have a downside risk in the mortgage market and in the thrift institutions. Savings banks are still very deeply in the red on an operating basis, despite the interesting kinds of ways that their accountants let them "report" and "disclose" to the public. The savings and loan industry--maybe 40 percent of it--is still in the red on an operating basis. To add to President Boehne's comments with regard to interest rates: If interest rates go up 100 to 150 basis points, that would move the proportion of the thrift industry that is having operating losses to something like 75 or 80 percent. Housing doesn't stabilize--all generalizations are false including that one--it either goes up or goes down. And my guess is that it's going to go down because of the quality of mortgage paper and because we have now used up that backlog in demand for housing that resulted from low levels of housing starts previously. So, I think there are several downside areas in the economy.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Well, Mr. Chairman, Mr. Boehne detects some optimism in his District. I would say that in our District there is euphoric ebullience everywhere. I'm not sure that that actually reflects the reality of the situation but confidence levels are very, very high, not only among business people generally but among our directors at both the branch level and at the head office level. Virtually every sector continues to strengthen; we're certainly in an expansion phase of the business cycle in our part of the country and apparently in the nation as a whole. In all of our important industries employment and orders are up substantially. The retailers had very, very vigorous sales over the Thanksgiving holiday and that gave rise to great optimism regarding the Christmas season. And that seems to be borne out by the tremendous traffic in and out of the shopping malls in all of our major cities. Interestingly, it's not just people parking in the parking lots this year and going around and looking; they are actually buying. My retail contacts tell me that sales at this point are very, very good. Housing is quite good. Business lending by the major banks in our area has improved substantially; consumer lending has been good for some time and that's remaining quite healthy. There are a few trouble spots that we've mentioned before, particularly in the agricultural sector and in the export sector. There are parts of the District that are not doing as well as others; but even representatives of those areas are very encouraged by the improvements that they see. The only places about which I have real concern are the rural areas where unemployment continues to be very high, and I don't know that that is going to improve very much. The great concerns among people that I talk to are twofold: basically, interest rates and the deficit. And they go together.

Coming to your question about what the concerns are looking out six months, I would differ from Jim's forecast only in degree. I would think that growth in 1984, particularly in the first half, is going to be somewhat stronger than the staff forecast. And going along with that, I think inflation continues to be a risk that is out there for the next 6 to 12 months, and my projection of interest rates and of inflation would be somewhat higher than the staff's. Let me say one other thing in terms of inflation: I think that higher corporate profits are going to be translated at some stage over the next few months into wage pressure. Certainly some of the give-backs from the unions are going to decrease and there probably will be some pressure for actual increases in wages as a result of the good performance of corporations over the next several months. On the other side of the inflation picture, we have had relatively slow monetary growth and the wage picture and commodity prices are not all that bad at the moment. So, I guess those factors temper my concern somewhat. But I come out on the bottom line feeling that we're going to have a stronger economy in '84 than is projected by the staff and that we're going to run the risk of higher inflation than is being projected.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Mr. Chairman, since you asked us to address ourselves to uncertainties, I see some very critical ones in the wage area, the dollar area, oil, and developing countries. But even though most of these happen to be risks that fall on the down side, they are not of a kind that one can guard against by leaning toward the up side. So, I think that the principal risk is really of more inflation than we anticipate. I agree with Bob Forrestal that these profits are almost bound to convert themselves into wage increases, particularly later in the year--September, I think--when we get to the UAW contract. With productivity gains diminishing quite abruptly early this year, capacity utilization diminishing at a surprising rate, and unemployment diminishing at a surprising and a very gratifying rate, all that points in the direction of upward pressure. Now, the other side is what may or may not happen to the dollar. If the dollar should go down abruptly, our exports will rise with a considerable lag. Our interest rates will rise very rapidly--not necessarily because the Fed does something about it but because capital imports can be seen in advance to be diminishing and the benefit of keeping interest rates down will disappear--and that could produce a considerable downward bias [in the dollar]. The LDC situation, [though] much improved, is still with us. It is still a major uncertainty. The oil situation I mentioned because people who watch what is happening in the Persian Gulf seem to think that the danger of a closing of the straits [unintelligible] is greater than it has been in the past. That would [result in] an increase in prices and a reduction in economic activity--the same [sort of effect] as [that from] the other oil shocks. That [potential] situation has a very [low] probability but very high risk if it were to occur. On balance, if you add these up, we have a number of risks on the dollar side; we can't really guard against them by leaning in the other direction. And the danger of wage increases and price increases is one that we can take into account and should guard against now.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Well, as I've reported for the last year or so, the Middle West has been very slow to join this particular party. But I do think there has been a significant improvement over the last few weeks or months, and at this point we really are on board. On the consumer side, all the current reports we get for retail sales are very, very strong, and double-digit increases are fairly common. Just wandering around stores, as I have done the last week or so, one can see that the traffic is very, very high. Even in the industrial sector there is an improvement; most of the basic sectors in the Middle West are doing better. They still are at comparatively low levels; compared to, say, 1978 or 1979, they are operating at 40 to 50 percent of what they used to think was a good level. But still, that is an improvement from what they were experiencing just a year ago. So, I think on the industrial side, there is improvement also.

With regard to the risks, I think they are the same ones that have been pointed out. Interest rates are high. I think people are amazed that we've had as good a recovery as we have had so far at this particular rate level. That suggests in their minds, and mine as well, that if there were any significant increase in rates, it would have the impact of shutting this [recovery] down somewhat. On the inflation side, I think there is a high level of suspicion that the stated rate of inflation somewhat understates what people think is a more practical rate of inflation. On the price side, most of the people I've talked with are sitting on the price button ready to go as soon as they can get increases across. The operating ratios are low enough that they can't pull it off; but as these ratios begin to creep up, I think they are going to try to push price increases forward as fast as they can. On the wage side, most of the people I've talked to suggest that they are still able to get 6 percent settlements by and large but they are having to work very hard to accomplish that. And as has been pointed out, there is an expectation that as profits begin to improve in a very significant way, that will form a pretty difficult environment in which to continue to pull off these very tough settlements. But as I add up these risks, I still think the fundamentals are in place for a continuation of recovery. The risks, [as] we look at them, are not significant enough to have a major impact on what I think is going to be a pretty good 1984--not very different from what the staff forecast suggests.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Mr. Chairman, most of what I wanted to say has already been said in one way or another--especially by Governor Wallich. However, my assessment of the downside risks is not quite the same as his. I'm not quite as guarded in my outlook. It seems to me that activity is likely to continue strong over the next year, particularly in the first half of the year, and to decelerate somewhat in the second half but still expand at an acceptable rate with unemployment continuing to fall. So, I don't see business activity falling off to unacceptable levels over the period of the next year. I'm a little more optimistic on the inflation outlook than I think most people have expressed. I don't share the same worry with respect to the wage outlook. I think the wage picture is probably still one of moderation. It's hard to see that profits are going to continue to expand at such a rate as to weaken the resistance to higher wages and improve really significantly the bargaining position of labor. So, I would expect continued moderation in wage increases. The energy picture looks pretty good and the outlook is for moderate--not runaway--increases in food prices. So, if there are going to be any strong inflationary pressures, it's hard for me to see where they are going to come from. So, I see the inflation outlook as reasonably favorable--pretty much as the staff has forecast. Along with the vulnerabilities listed by Governor Wallich, I would simply emphasize, as others have pointed out, that the major vulnerability is higher interest rates than we now expect--that is, higher than in the forecast. A number of people have pointed to that, and I think there is possibly a real danger of interest rates being substantially higher than they are now forecast. The reasons for that, obviously, are the deficit, the increase in private credit demands, and the falling off of capital inflows. All of these possibilities would operate toward putting upward pressure on interest rates. And if that happens, I think the economy will be very vulnerable and possibly in danger of some damage from that development. I don't, however, expect rates to increase substantially, although I recognize that as a possibility that could affect the forecast, as I pointed out. On balance, I would say that the probability is about 50 percent on being able to maintain current levels of interest rates; and if we're able to do that, I think [the economy] will be in good shape.

CHAIRMAN VOLCKER. I might ask Mr. Kichline to comment on the point Mr. Corrigan made earlier, which is the inverse of this profits point. Is it true that labor costs are going up much less--or historically very little--compared to prices at this stage? You don't have to address it now unless you want to. We'll turn to Governor Partee.

MR. PARTEE. Well, you asked for a different hypothesis on what is going on. A surprise this afternoon is the amount of ebullience reported in Minnesota, which I would think would be in a cold deep freeze, and in Pennsylvania, which has not been a boisterous state over the years. My only comment in response to that would be that businessmen are inclined to look at their performance compared with a year ago; that still is the way that 90 percent of the businessmen look at their activity. We have now completed a year of recovery and, therefore, the November-to-November increases are as large as any they've seen--in fact the largest they've seen for the whole period of the recovery. And they probably are the largest they are going to see anytime in the expansion; [the increases] will go down from here rather than up. So, I'm wondering whether we're not picking up a degree of false optimism in the business community and whether in fact it doesn't lay us open to the possibility that high expectations will be frustrated in the months to come. I see that at least as a possibility.

Now, as I look at the projection, the greatest problem I have with it--I've had it before--is that the saving rate is too low. I think it ought to be higher; I would expect it to be higher given income performance, given incentives to save that we have in the economy now, and given the general notion of maintaining some kind of reasonable ratio of financial saving stocks to total income. The way we would get the saving rate higher is either by having higher income or lower expenditures than are being forecast by the staff.

CHAIRMAN VOLCKER. Or use the Federal Reserve numbers?

MR. PARTEE. Well, I can't even understand what is involved in that argument since we haven't been briefed on it, so I can't do that. We could have higher income to the extent that there is more demand in the economy outside the consumer sector, principally perhaps inventory demand. That's a possibility; we could have more inventory demand and more income generation as a result of that and, therefore, higher savings can result from higher income than is being projected. On the other hand, we could have lower income if productivity gains in the short run are going to be considerably stronger than the staff has projected, which certainly seems possible, or if the wage rate environment stays placid. There are a lot of indications that it is pretty placid and, therefore, it seems to me that is possible. Now, if we have a reduction in consumer spending relative to income in the months ahead and if businessmen are expecting very good gains--gains that are too large for them really to anticipate getting--they will be disappointed in the months ahead. That would provide a basis for an even smaller rise in business activity than is being forecast by the staff and that's consistent with the M1 numbers. Therefore, slow growth in M1--to bring in the monetarists in the crowd--is consistent with this last hypothesis.

MR. BOEHNE. Do you believe it, Chuck?

MR. PARTEE. I don't know.

MR. RICE. Isn't that what you want?

MR. PARTEE. No. I think that the staff projection would be an almost ideal outcome, if we could get the staff projection.

MR. RICE. What about 1 percent less growth?

MR. PARTEE. I don't think so. I wouldn't want 3.3 percent rather than 4.3 percent growth for the next year. I think something on the order of 4 percent is fine. I would like to have maybe a little more real growth and a little less inflation than in the staff projection, but I think it's a very good projection. I think we probably would find that we can't live with a number a good deal lower than that for very long, particularly in the environment we'll have next year. But I think it is a very good [outcome]. If I were asked to state what my objective is for the economy in the next year, I would not be far off the staff projection. Anyway, I was trying to make a case for a smaller rise [in business activity]. You asked for something far out; there is a far-out scenario.

MS. TEETERS. But is your assessment of the situation that growth would be lower than the staff projection?

MR. PARTEE. Yes, that it would be lower because a rise in the saving rate would cut consumption, and consumption would have a feedback effect on business attitudes--considering that they're overly optimistic now.

VICE CHAIRMAN SOLOMON. The staff already has factored in a much smaller rise in consumption--by $33 billion dollars, I think.

MR. PARTEE. I know, but their saving rate continues very low.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. Well, I'm on the opposite side of Chuck. I think there are a couple of areas in which the staff forecast is likely to be a bit low on the real side next year. One of them is business fixed investment. I can't demonstrate any evidence of this other than a gut feeling, I guess. The staff forecast is well above what the surveys of intentions to spend are indicating, but those surveys have been practically useless in terms of the trend of business fixed investment in recent years. Given the kind of confidence we hear about and given cash flows, I think we're going to see more investment next year than the staff has forecast. The second area is inventories. I have heard over and over again the story that Jerry Corrigan is telling us--that inventory/sales ratios are so blooming low now that delivery times are lengthening--and I think we're going to see some price reaction to that early on in 1984. The staff forecast, incidentally, has a build-up of inventories and inventory investment to what might be called a normative relationship with GNP of around 1 percent of GNP. That means, in effect, however, that the inventory/sales ratio shows no improvement whatsoever; it stays at its third-quarter 1983 level, which I think is the lowest inventory/sales ratio ever in terms of GNP. My guess is that if final sales continue to be fairly strong--and I think they are likely to be --that we're going to see some efforts to build up inventory more than the staff has indicated. Secondarily, I worry about--

CHAIRMAN VOLCKER. Let me just make sure that's correct; I just want to have it confirmed. You have $35 billion a quarter--or more than that--on average. That would be no increase in the inventory/sales ratio?

MR. KICHLINE. In 1972 dollars the inventory/sales ratio was around 3.03 or 3.04 and it stays flat throughout 1984. So, in real terms it is unchanged.

CHAIRMAN VOLCKER. What am I looking at--unreal inventories?

MR. KICHLINE. You're looking at book [values].

MR. GRAMLEY. The other area I worry about is that the labor force may well continue to show the kind of very slow growth we've seen during the course of 1983. In the staff forecast, growth of the labor force doubles in 1984 so we get less progress in reducing unemployment than I think may take place. If it turns out that we get more real growth and a greater drop in unemployment relative to the growth rate, then I think the prospects are for a worsening of price inflation as the year progresses--more than what the staff is forecasting. I don't think the risks are for huge overruns on either side; one percent more in real growth and maybe 1-1/2 percent or so on the price side is the most I can see. But if we were to get that kind of situation, then by the last half of the year we would be looking at a rate of price inflation between 6 and 7 percent and we would be going into 1985 with a much higher level of resource utilization and with the near certainty that, unless something slows it down, the rate of inflation would worsen. And that's what I think we need to focus on.

CHAIRMAN VOLCKER. Governor Teeters.

MS. TEETERS. Well, as I listen to the discussion around the table, I come to the conclusion that how 1984 turns out is right smack in our laps, [given] the sensitivity of the economy to interest rates --the current levels and changes in interest rates. If they begin moving upward and if that gets translated to the mortgage markets, we may as well shut that one down. So, our decisions about where interest rates should be and their movements during the year are going to be the crucial factor in determining whether we achieve this forecast or not. I agree with Chuck that this forecast would be the ideal outcome. And if we could achieve it, we could say that we actually were conducting monetary policy in a way that created a situation [that maximized the prospects] of a return to relatively full employment. But I do emphasize that I think the economy is now so sensitive to interest rates--particularly starting from the level that they are--that a move of 100 basis points would completely turn around the forecast in practically every sector. There is also built into the forecast a 10 percent decline in the international value of the dollar, which does have direct price implications for next year also. So, the whole combination of this, I think, turns on the decisions that are made by the FOMC over the next three months.

CHAIRMAN VOLCKER. I'm out of names. Mr. Roberts.

MR. ROBERTS. Just a very brief comment, Mr. Chairman: In my experience with businessmen, they always extrapolate the present and [unintelligible]; for example, it causes them to underestimate inventory/sales ratios because they always assume that sales are going to continue as [they see] them now. I'll talk tomorrow about lead effects that we ought to be considering here. I'm not that optimistic about the economy.

CHAIRMAN VOLCKER. Maybe you ought to tell us more.

MR. RICE. Why aren't you optimistic?

MR. ROBERTS. Well, I just wanted to introduce the idea that the liquidity flows through the economy, as I'm sure everybody around this table knows, operate with differential lags. I've been concerned all year about inflation later this year and in 1985, which I think is going to happen. I was not concerned about the fragility of the economy and that is because of the flow of liquidity through the economy. We've had a real constraint for some time on M1, whether you look at it as 13 percent in the first half and 5 percent in the second half, or whether you look at it as 4 or 5 months with no growth. I think that by the second or third quarter of next year we're going to see some restraint in the economy, with an output effect flowing through on a near-term basis and then an inflation effect late next year. It's the worst of all possible worlds. I would anticipate that we will have real growth in the 3-1/2 percent area next year and that we still will have troublesome inflation late in the year.

VICE CHAIRMAN SOLOMON. Well, I guess we come out somewhat differently. The New York Fed staff's forecast is for stronger growth than in Mr. Kichline's forecast. So much of this is "iffy" that I won't bother going into the components and how they arrive at their forecast; they arrive at it, incidentally, with a much higher productivity guess. I'm particularly impressed, unfortunately, by the increased talk I hear in the financial markets about rising inflationary expectations. And I hear a lot of it. So, from that point of view, there's a fairly clear implication for some snugging up, possibly. On the other hand, though, the thing that bothers me is that the exchange rate is getting to be a looming menace in a difference sense. The higher it keeps going the more precipitously it's going to drop when expectations regarding the exchange rate turn around. It's going to drop at a time when we're nearer capacity utilization and it will have a much bigger inflationary impact. I'm not even talking about the developing countries burden. I think it's a real time bomb.

So, I am in a quandary as to where these conflicting analyses would lead one. If one were looking just at the domestic scene, I think it would be important to affect the psychology and curb somewhat these rising inflationary expectations. I don't think that a quarter or a half percentage point is going to bring that much of a change in housing and the real economy that it is going to slow down the momentum that much, but I think it would have a very salutary psychological effect. However, I don't know whether it would push the exchange rate up even further. It would be my guess that it would and I just don't know if we can afford to be that asymmetric in our monetary policy in regard to exchange rates. When they are falling precipitously, we are all willing to tighten monetary policy; when they are rising into the stratosphere, we're not prepared to liberalize monetary policy--for reasons I understand, of course, and with which I sympathize to a large degree. I don't know how to cut this dilemma. The easy way out would be to say: Let's wait a few more weeks until what is happening becomes clear. But Ted Robert's scenario--even though we don't believe that it's the most likely one--certainly is still in the realm of possibility. I don't think there would be any chance of a recession, but there could be some slackening of growth. At the present time we think there is enough momentum that growth probably will be coming in higher than the 4.3 percent; we're thinking more in terms of 5 percent.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. With regard to economic activity in the Tenth District, I think we've joined the national recovery certainly, with the exception of two major sectors: agriculture and energy. And both of those will take much longer to work out. The agricultural situation will depend largely, I think, upon some drop of the dollar--if and when that ever occurs--to encourage exports; and energy everybody knows about. But by and large I think the view of businessmen and market makers in our part of the country is not euphoric but it is very strong as to the outlook six months or so hence. In talking to those individuals, they are almost consumed with the federal budget deficit problem and the fact that the Federal Reserve is really the only player on the field and that inflationary expectations are just under the surface--whether they come from corporations and businesses taking the opportunity to try to increase their prices and hopefully make them stick or from wage pressures. [The view is] that inflationary expectations could take hold and be a reality, particularly in the markets, unless the Federal Reserve is very visible.

In general terms, we would expect the staff forecast to be the best of all worlds if it could be achieved. But our best expectations are that growth will be somewhat faster in the first half of the year and then slow down toward the latter part of the year. With regard to inflation, our projection would be higher than the staff's and as a result--this may be ahead of the discussion--I probably would join those who say a little snugging up now would serve us well in the future.

CHAIRMAN VOLCKER. Mr. Kichline.

MR. KICHLINE. On Mr. Corrigan's point, we don't have a chart here. We have all sorts of numbers but he has the chart. We do have very clearly, though, a situation where we assume that unit labor costs in 1983 are rising about 1 percent and our deflator forecast is something like a 4-1/4 percent increase. So, it's a very wide spread. It shows up in corporate profits, and corporate profits in this cycle --for the first four quarters of the recovery, assuming our fourth-quarter forecast is correct--have risen more than in any other postwar cycle. They are close to the increase in 1975, but are substantially above the cyclical performance for the first year of a recovery. Two comments with regard to that spread--

CHAIRMAN VOLCKER. If I may just interrupt you: The increase in profits is stronger?

MR. KICHLINE. Correct.

CHAIRMAN VOLCKER. How about the relationship of profits to GNP or corporate product?

MR. KICHLINE. Well, it's up because the profit share and notional margins have been rising. We think it will be at the highest level at the end of this year since 1977-78--a six-year high. So, it has done very well as a share or absolutely. Two particular comments: First, going back to the staff's inflation presentation, we believe that corporations essentially price off some notion of unit labor cost and a markup over that. In effect, what they're doing is looking at some notion of trend growth in productivity; and trend growth in productivity, we think, is better than they may be using. So, it is showing up here in terms of attempts to price fairly aggressively and they're getting more profits than they might otherwise think. My second point is a technical comment: In measuring the GNP deflator, as you know, import prices are subtracted out in the short run. In the first half of this year import prices actually declined and were about unchanged in the third quarter, so that for much of this year we think that substraction process has artificially raised the GNP deflator because the benefits of those import prices measured in consumption, investment, or whatever, come along with a lag. So, our story is that this has been an unusual year.

CHAIRMAN VOLCKER. But then the consumer price index should be lower but it's not; it's higher.

MR. KICHLINE. Well, it's higher than the deflator but there are different weights and other things going on. Obviously, service prices, for example, are very important. We suspect that 1984 will be a year that returns much more to normal in the sense that our forecast has unit labor costs and the deflator rising about the same amount, so that the gap we're seeing now we think will evaporate.

MS. TEETERS. Jim, a technical question about this large increase in profits we are talking about and the increase in the share and the probable effects that this could have on wage demands over the course of the year: If corporations end up with higher profits, doesn't that take some of the pressure off price increases also?

MR. KICHLINE. Well, if we go back to the notion that some sense of normalcy is restored, which I think is happening here--profits have been very weak for the last 3 or 4 years--and if indeed productivity is improving, I think it all depends ultimately on the context of the market situation that we have. In our forecast, markets generally will not be so tight as to allow corporations to pass aggressively through whatever price increases they might want. There is restraint both domestically and from the import side. So, I think on profits you're right. Ultimately, how it works out will depend in part on how this economy evolves in 1984.

CHAIRMAN VOLCKER. How are profits in the manufacturing sector alone? You can cover that tomorrow.

MR. KICHLINE. Okay, in detail.

MR. CORRIGAN. Well, when you consider the automobile industry alone, it's going to make $5 billion this year. I suspect the profits in manufacturing are up too--just as sharply, in terms of increases in profits, as the rest of the economy.

CHAIRMAN VOLCKER. They probably are up pretty sharply, but I don't know where they are in absolute levels.

Well, I think we might as well quit for the evening, if nobody else has anything to say on this subject, and turn [tomorrow] to a preliminary discussion of the 1984 ranges. I don't find myself as excited about this forecast and its idealized aspects as some other people do here. My ideal forecast always has a declining inflation rate. Thinking back to our discussion last month, we didn't draw much of a conclusion. This is the time to come to a conclusion, I suppose, in terms of inflation strategies as well as other objectives of our long-term forecast. We'll put that on the table bright and early tomorrow. Nine o'clock is bright and early.

[Meeting recessed]

December 20, 1983--Morning Session

CHAIRMAN VOLCKER. We can begin with a discussion of the 1984 ranges. There was some discussion in the Congress about requiring ranges for 1985, or two years ahead, and we might want to consider what we might say about 1985, at least in a qualitative way, when we present the 1984 ranges. Obviously, we don't have to decide this now or even be that precise about 1984 now. But if anybody has strikingly different feelings than are encompassed in the preliminary ones--or a radically different way of looking at things--this would be the appropriate time to bring it up. I think the Bluebook paragraph or two about this was a good discussion of the various considerations that have to be brought to bear. It does fit in with our inflation discussion last time about what we think our responsibilities are and what the practical possibilities are for dealing with inflation over a longer time-frame because these kinds of things are reflected in the long-term targets. I don't know whether you have anything to add, Mr. Axilrod, to your comments in the Bluebook.

MR. AXILROD. I don't have much, Mr. Chairman. I could very briefly point out what we were trying to do there. As you mentioned, in the first instance we were trying to discuss the tentative ranges in terms of their consistency with regard to inflation objectives. Obviously, the 1984 tentative ranges are consistent with further progress in reducing inflation assuming, as is clear there, that the Committee is looking toward lower rates of inflation than the 5 percent that is currently projected for 1984. And that, of course, would have particular relevance for anything the Committee might want to say, qualitatively or not, for 1985.

On some more technical points with regard to the ranges: For 1984, the M1 range of 4 to 8 percent is a reduction, of course, from the range for the second half of 1983 and we think it implies, given the 9 percent nominal GNP, a velocity increase on the order of 2 percent without any interest rate rise--somewhat lower than the trend for the postwar period years, which is around 3 percent or so but it has occurred in a period of rising short-term rates. Now, the velocity of M1, as everyone knows, is going to be very uncertain and probably will be very different if there are significant interest rate movements up or down from the levels projected. But given this projection of very little interest rate change, we think an M1 increase around the middle--or more likely in the upper part--of the 4 to 8 percent would be the likely outcome, consistent with the projected nominal GNP.

I ought to point out two other things: As noted in the Bluebook, the [tentative 1984] M3 range was decreased to 6 to 9 percent. The problem may be that it would squeeze M3 down pretty much if a considerable part of the credit flows continue to go through financial institutions. We had two reasons for thinking it would be possible to get M3 growth at 9 percent or below. One had to do with the continuing efforts by banks to raise funds abroad through Eurodollars and not domestically through CDs, which would tend to hold down M3 growth, particularly if foreigners put their money in dollars abroad. With regard to M2, I would also point out that a 1/2 point reduction in the range from 7 to 10 percent to 6-1/2 to 9-1/2 percent might not be considered an effective reduction since the 7 to 10 percent range included 1/2 to 1 percentage point of further shifts related to the money market deposit accounts. And so far as we could judge, the amount of shifting in that 7 to 10 percent probably was on the order of 1/2 to 1 percent, but those estimates are always very difficult to make. Thus, a reduction of 1/2 point to 6-1/2 to 9-1/2 percent is not, in a sense, an effective reduction. Counterbalancing that, of course, is what we observe to be a normal reduction in velocity growth of M2 in the second year of a recovery, which would for any given nominal GNP require somewhat higher M2 than might otherwise occur. I think those are all the preliminary comments I would have.

MR. WALLICH. Could I ask you a question, Steve? When we set these targets tentatively in July, I think all of the aggregates were at the tops of their ranges. That is still the case for M2 and M3, more or less, but M1 has dropped to almost the bottom of its range. So, in effect, we've had a base drift of about 3 percentage points, haven't we? If we took this not just as a monitoring range but as a target, and if we wanted to arrive at the same level of M1 at the end of the target period, the end of the fourth quarter of 1984, we would really have to go not to 4 to 8 percent but 7 to 11 percent. I say that not because I intend to propose this, but just to indicate how base drift seems to change, if I'm not mistaken, what one thinks is the right thing to do.

MR. AXILROD. Yes. I have not made that calculation; I was planning to make it for the Committee at the February meeting when we knew the actual outcome.

MR. WALLICH. But something of that kind is the case, isn't it?

MR. AXILROD. Yes. If the center of the 5 to 9 percent range were where you wanted to start from, I'm not sure what the rate of growth would be. We can calculate it while we're waiting here, but it would be a higher rate of growth than from where you are now.

VICE CHAIRMAN SOLOMON. I think we've been fairly consistent in ignoring those kinds of considerations.

MR. PARTEE. That's been done and they did [unintelligible].

MR. WALLICH. Yes, then we drifted up; we're drifting down. I think the down is money in the bank, so to speak. And we shouldn't let go--

CHAIRMAN VOLCKER. Yes, but that would only be if you attributed some special importance to 7 percent or whatever it is. I think what we said at the time was that we would be perfectly happy with low growth if velocity were high and we'd be perfectly happy with high growth if velocity were low.

MR. WALLICH. Well, it doesn't change the calculations, does it, because velocity may still change? We can't expect that the--

CHAIRMAN VOLCKER. It changes the arithmetic, but I don't think there's any great significance to 7 percent. Mr. Morris.

MR. MORRIS. Mr. Chairman, I have a lot of problems with this, as you might surmise. It seems to me that the only range that we can have much confidence is going to be predictably related to a 9 percent nominal GNP growth is the range for credit. I've been arguing for a couple of years now that the changed character of M1 means that its relationship to the nominal GNP is not predictable. And it seems to me that I have two years of pretty good evidence on my side. To assume, as apparently is being done here, that we will get a more or less normal return to historical M1 velocity--I hope that turns out to be the case if that range is adopted--is an act of faith rather than an assumption with any scientific basis. I think the ranges for M2 and M3 are even worse, because the history of the last 25 years shows that in the second year of expansion on the average M2 and M3 velocity declined by 2-1/2 percent. Therefore, if one wanted to have the range wide enough to finance a 9 percent nominal GNP growth, the upper limit ought to be 11-1/2 percent. I'm not persuaded that the staff has made a very strong case to the effect that M2 and M3 velocity are going to be so much different in '84 than in the past. Also, this year being an election year, I would hope that we could adopt targets that we wouldn't have to be changing just before the election. We abandoned the M1 target in mid-1982 and we rebased our M1 target in mid-1983. To do it in mid-1984 might generate the implication that the Federal Reserve was changing course for political reasons. So, I think it's more important this year than in most years that we have some reasonable degree of confidence that the targets we're setting are compatible with our nominal GNP objective. I don't think we can have that confidence for these ranges for M1, M2, and M3.

VICE CHAIRMAN SOLOMON. You'd like to see them all higher?

MR. MORRIS. I don't know. I don't know where to set a range for M1 or what base [period] to use for it. I would rather eliminate M1 as a target. As for taking the position to call it something else --say, a monitoring range--to my observation the market doesn't seem to notice the difference between a monitoring range and a target. I think the M1 numbers there are probably sounder than the numbers for M2 and M3. I just am not persuaded that the performance of M2 and M3 is going to be that dramatically different from all previous second years of expansion in the last 25 years.

CHAIRMAN VOLCKER. Do you have evidence on the second year of expansion for the previous 25 years, Mr. Axilrod?

MR. AXILROD. I don't have the rates of growth at hand; I have the velocities at hand. They are almost impossible to analyze, of course, because of ceiling rates and all that. In the second year of expansion velocities of M2 were negative. That is, there were drops in velocity on the order of 3 percent after the first quarter of '61 in the second year of that expansion, 1 percent in the early '70s, and about 3-1/4 percent after the '75 trough. And 1980 is irrelevant, of course. Before the '60s, in the '50s, there were increases in velocity of about 1 percent. And those were all decelerations so to speak from the first year; some of the decelerations turned into negative velocity. We have assumed also a deceleration in velocity of M2. So, it's not inconsistent with this kind of cyclical experience. But we have the velocity continuing to be positive, which I think is probably also reasonable given the changed institutional circumstances. It also happens to be generally consistent with what we can make out of our models; both the M1 and M2 changes are generally consistent with our new M1 demand equation and the estimates that come out of our model for time and savings deposits.

CHAIRMAN VOLCKER. Mr. Solomon.

VICE CHAIRMAN SOLOMON. I want to respond to your comment that we might want to say something qualitative about 1985. Even though I know that we don't want to imply an automatic quid pro quo, which would be a tighter fiscal policy and easier monetary policy, it does seem to me that we have an obligation to spell out the overall terms [unintelligible] of the economic profile of 1985--if we decide to go that far--and that we ought to do it by starting out with different assumptions: meaningful action to reduce the budget deficit and the absence of that. It seems to me that we have an obligation not simply to preach this but to show our best view of what differences there would be in the economy, even though I know it's not clear beyond 1985.

MR. BALLES. Tony, could you speak up a little louder please? Some of us can't hear you down here.

VICE CHAIRMAN SOLOMON. I'm sorry. I was just saying that if the Chairman is going to spell out qualitative views in regard to 1985, we ought to describe the scenario in general terms if there is meaningful action to reduce the budget deficit and if there is not. With regard to the monetary aggregates, it seems to me that at the very minimum we should raise the M3 range 1/2 point to make it equal to the M2 range. I think it's a little restrictive for the same reasons that Steve has described. And it looks strange; I don't think it makes any sense to have it lower than the M2 range. In general, even though I'm sympathetic to what Frank says, I don't see that tactically at this point we can afford to drop everything but the credit target. I think that would be interpreted in some quarters as being politically motivated. I'm [not] quite as cynical as I was a few months ago as to the markets reacting differently to a monitoring range as against a target range for M1. I have the sense that the markets are being somewhat less knee-jerk in their reaction to the weekly M1 figure. So, it seems to me it would be appropriate to continue with our present structure of the three target ranges--for credit, M2, and M3--and a monitoring range for M1. That's all I have at the moment.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. With regard to saying something about 1985, I think that is a good context in which to talk about our views on the reduction of total spending over a period of years. I'd at least start out with Frank on that, but I think nominal GNP has to be reduced over a period of some years. And if we're talking in the context of 1985, then I think one can distinguish it from being an annual target. And that really is our strategy: a gradual reduction of total spending in the economy. Then, from that I would go on and diverge from Frank and say that money is important because it gets us there and that the rate of growth of money would be gradually reduced over time in order to accomplish this total spending strategy. In that respect, I think what is in the Bluebook is reasonable. I would go much along the line that already has been put forth, and that is that reducing the money supply is important over time and where we come within the target ranges depends on what happens to velocity. We have some ideas about that but we don't know ahead of time. In some sense that kind of communication deals with what we need to say to the markets, which is how we're going to react next year to surprises. We should be very open to saying that there are these uncertainties and that when we get surprises this is the basic structure within which we will look at those surprises.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I think we really have two questions that we have to address today. The first, of course, is which aggregate or aggregates we're going to emphasize. And the second is what the numerical ranges for those targets ought to be over the coming year. As I suspect most of you would think, I strongly favor returning to M1 or increasing the emphasis on it. I'd make it the primary target. It seems reasonable to me to suppose that, given the sharp increase in the velocity of M1 in the fourth quarter, the probability is much greater that the traditional relationship between M1 and GNP may be resuming. In addition, I think one has to judge M1 against the alternatives. And it seems to me that the case for M2 and M3 and almost anything else I can think of is really not as good as it is for M1, despite the imperfections that M1 obviously has had in the past. If the Committee does agree to increase the emphasis on M1, then I think we ought to consider lowering the 8 percent top that we tentatively set for next year. If we approach the target from the standpoint that the Bluebook does in paragraph 12--the paragraph Steve was mentioning a while ago--an 8 percent growth at the top, given the projection of nominal GNP of 9.1 percent from the fourth quarter of this year to the fourth quarter of next year, would imply a rise in velocity of only 1 percent. That is not a figure to which I would attach a very high degree of probability given the recent resumption in velocity [growth] of M1 and also the probable absence of any further major changes in the regulatory area. More fundamentally, 8 percent seems to me just not really consistent for any long period of time with our stated objective of dealing over the long run with inflationary problems. So, what I'd really like to do is to knock a couple of points off that. That's probably not going to be acceptable to this group, in which case I would argue that we ought to put the top maybe at 7 percent, or if we want to be a little devious say 4 to 8 percent but that we're just going to use the [lower] half of the range. But I don't like that [latter] approach, really.

So far as M2 and M3 are concerned, I could accept keeping the preliminary ranges where they were set in July, although as Steve pointed out a minute ago and as the Bluebook mentioned, that doesn't really represent any reduction in the rate of growth in M2 for 1984. So, I think 6 to 9 percent would be a preferable figure and would give a stronger signal to the market of our anti-inflationary resolve. They will look at that and will be aware that if we stick to our tentative 6-1/2 to 9-1/2 percent range, we really haven't made any effort because of the way the base was set. So far as M3 is concerned, if there are these technical reasons for raising that range, which seem plausible to me, then I wouldn't mind having it at 6-1/2 to 9-1/2 percent. For 1985, clearly, the purpose ought to be to cut whatever ranges we adopt still further, in keeping with our often stated objective of working down the rate of growth in the aggregates over the long run. So far as figures are concerned, I think we have to wait until we decide what we want for 1984 before we try to put any [specific] numbers on that.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. As for the 1984 targets, I see no reason to change what we did in July. As far as the M1 target is concerned, we already have an implied reduction of 3 percent in those targets through the base drift, as I said before. I see 4 to 8 percent as meaning 6 percent on average; that implies a velocity gain of 3 percent and nominal GNP of 9 percent, and that seems to me about right. I would like to restore M1 partly but not fully yet and I would like to maintain the wider range, given the uncertainty. I have nothing to say on M2, M3, and credit.

As regards 1985 and the possibility of some sort of reciprocity between fiscal and monetary policy, I think there's an element of realism here, as Tony says. Analytically, if we raise the rate of growth of money it would just lead to higher prices in the long run. But it's also true that if the budget is tightened and money remains on course, the drop in interest rates is not going to be sufficient to overcome the reduction in demand. So, what we ought to have is a temporary acceleration, if one could do that, of the aggregates. I am quite skeptical of that degree of fine-tuning. And I really would prefer, tactically and strategically, to say that our collaboration comes from allowing this interest rate drop to take place that a reduction in the budget deficit is bringing about, recognizing that there's some risk on the down side that the interest rate drop may not be enough to keep GNP on track. Looking further, [beyond] 1985, I think we should aim at ultimate price stability. I think we're all aware that there are high costs. It's not very likely that we will achieve that on a steady trend. It's much more likely to happen as a result of another recession before which there will be some acceleration of inflation that will then lead to a sharper drop in prices, hopefully to the neighborhood of stability. But we can't plan on that, so we have to plan on some kind of downward trend in the aggregates to achieve reasonable price stability.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. Well, Mr. Chairman, I would agree that in some ways the key question before us now is 1985 rather than 1984. We could get lucky and get through 1984 in reasonably good shape, but I think the prospects of being able to keep the economy growing on a noninflationary--whatever that means--way in 1985 at this juncture will be very, very [low] for all the reasons that have been mentioned before: the deficit, the likely build-up in business external financing certainly by that time, and at least in my judgment a clear risk that the inflation rate itself will have broken through the 5 percent or higher threshold by the end of 1984. In that setting I do think that if we were lucky, we could squeeze through 1984 with something that might look like the Greenbook forecast. But unlike others, I would not be particularly sanguine about that result. I certainly don't consider it optimal by any stretch of the imagination; indeed, I guess I would argue that if we really want to try to insure the continuation of a pattern of a growing economy in 1985, the best thing we could do to produce that result might be to introduce a little more restraint in 1984. I'm under no illusions about the extent to which any of this can be done, or fine-tuned, but that would be the direction of my thinking.

More specifically, in the context of the tentative 1984 targets, I am inclined to the view that the upper end of the M1 range is too high. As best I can understand the credit aggregate, I think the upper end of that is too high as well. I don't have any particular views on M2 or M3, although I certainly would not be allergic to the symmetry in M2 and M3 that I think Mr. Solomon suggested. There is another question that is laced in and out of all of these, and that's whether we want to do anything in terms of moving in the direction of suggesting through your oratory at least--perhaps a little more directly than we have in the past--that our primary, though by no means exclusive, objectives are more in the areas of price and financial stability. I don't know if you're game for that right now but if we can begin to nudge ourselves in that direction without going overboard, I think it could serve the purpose of this Committee and the economy very well.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. Mr. Chairman, we did have a good discussion at the last FOMC meeting about certain relationships and certain theories of inflation and inflation's forces and factors. It seems to me that that discussion is relevant to an outreaching for 1985 and to some extent to our considerations for 1984. There is some validity to the notion that by 1985 the changes in M1 [will be behind us], however uncertain its velocity and however difficult it is to anticipate the results of contemporaneous reserve requirement accounting, and that what we do in the balance of this year and in 1984 will have a bearing on the conditions and activity in 1985. I would, therefore, not forget M1 regardless of the uncertainties that I mentioned, but I believe they are such that we should not yet move M1 up in importance in the exposition of our policies and how we are going about [implementing] them. It seems to me that the market is focusing somewhat more on free reserves and on borrowing levels than previously and that the almost obsession with M1 has diminished somewhat; I think that's probably salutary. Perhaps that means the market has a better understanding of what we're really trying to do. So, I wouldn't forget M1; I would keep it among the targets, certainly, but I believe the uncertainties are such that we need a wide range for 1984 and, therefore, the 4 to 8 percent is acceptable.

With regard to your question on 1985, I would join those who support your presentation of perhaps a bit stronger language regarding our reluctance to fund total expenditures, a part of which is the 40 percent that is [spending by] the federal government. But I'd like to pick up those additional tens of billions that are off-budget financing and look at the situation as one in which the financing is much more than 40 percent and getting up to the 50 percent or better level. So, I would caution that our 1985 targeting of the aggregates and our policies, framed in view of M1 changes and credit changes, are not likely to be such as to fund the levels of spending that private demand and public demand unreined would imply. It seems to me that we are in a position of increasing that warning. I would also support some language indicating that, when we know what the actual growth in the aggregates was in 1984, our policy would most likely be to reduce the targets for 1985 from the actuals of 1984.

VICE CHAIRMAN SOLOMON. Do you mean lock ourselves in on that one?

MR. MARTIN. I would have language indicating that, given the total spending that seems likely to occur in the absence of remedial action on fiscal policy, we would find it difficult in the public interest to fund all of that spending and that our targets would most likely take the form of [lower figures than the actuals in 1984]. I wouldn't use any numbers, Tony. How do we know what the actual 1984 performance is going to be? I was reviewing last year's Bluebook--no offense intended--and I don't know how in the world we can set numbers for 1985 when the 1984 actual is likely to be way off the expected.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, I too think that 1985 is going to be a critical period, and I think it is important that we give the markets some qualitative description of our intentions for 1985. That means that 1984 targeting is going to be all the more important because of the carryover from that year into 1985. But I hope, as I think Governor Martin was just saying, that we will resist any Congressional or other pressures to quantify the targets for 1985. Our strategy for both years should be, as has been stated before, an objective of having a steady and gradual reduction of the rate of money growth over time. The long-term plan, it seems to me, is to keep inflation in check and to achieve price stability in the long run, and that objective is equally applicable to 1985 as to 1984. With respect to the 1984 targets themselves, I guess it depends on whether we look at the rate of growth in money that we have had from 1982 until recently or whether we look at business expansion. Either way, as I said yesterday, I believe the rate of growth in the economy is going to be stronger than many people think and, therefore, the danger of recession in the latter part of '84 is perhaps not as strong in my mind as in others. I also remember the discussion of inflation at the last meeting, and I'm concerned about that. The other thing that I would say in a general sense is that I believe the markets are going to be looking at what we do for both years--certainly for '84--and our credibility is going to be very much looked at over the next several months as we announce these targets for '84.

Specifically, on the numbers themselves, I would agree that M1 should be elevated to a more prominent position in our thinking. I don't get very hung up on whether it's a monitoring range or a target but I think we ought to look at it more carefully than we have. I would drop that top number, as others have said; 7-1/2 percent seems to be an appropriate number. The other two aggregate ranges seem okay to me. And I agree with Mr. Solomon that having some symmetry between M2 and M3 makes some sense, so I would agree with the tentative '84 numbers [for the M2 range] in the Bluebook--6-1/2 to 9-1/2 percent--but I'd use the same numbers for M3. But, again, I would move that top of the M1 range down from 8 percent to something in the 7 to 7-1/2 percent area.

CHAIRMAN VOLCKER. Governor Teeters.

MS. TEETERS. Well, I agree with [Governor Martin]. Let me take the 1985 issue. First of all, I really don't think we can forecast. As I look back over the past 5 years, we've missed turning points and almost everything that has happened--well, not everything that has happened because I think that we have to forecast and the staff has done a good job. But to lock ourselves into something that is as far off as two years, with all the variety that can go on, I think is a mistake. This year we have changed targets and we've accommodated to changes in the economy as they have occurred, as changes in the various aggregates have come along, and as our forecast has changed. I must say that from my point of view the markets responded [well] to what was a very reasonable shift in policy. We've kept them informed about what we were doing. And rigidly setting targets, particularly out two years, when we have a changing economy doesn't make much sense to me at all. If you remember the exercises of 4 or 5 years ago when we ran the econometric model [to evaluate] probabilities, we found that we are pretty good at forecasting the next quarter or the next two quarters. We begin to lose that and become less certain three quarters out and even more uncertain four quarters out; and by the time we get to a year-and-a-half or two years out, the econometric models give us almost random numbers. We might as well do what the Administration does for their 5-year projections, which is to take an annual rate of growth, just string it out, and put in a hopeful inflation number, because those forecasts for 2, 3, 4, and 5 years out don't have any reality to them. So, to lock ourselves in now to something for 1985 doesn't make any sense. I think we can talk about it. We can talk a great deal about the fiscal policy problem and what that implies for monetary policy, but I don't think we have to lock ourselves in.

As for the 1984 targets, [many of] you seem to assume that we're going to be all right in 1984. I think there are a lot of hazards out there. We still don't know what M1 is doing. I think we need a wide range on it; I'm not terribly satisfied with 4 to 8 percent, but I certainly wouldn't lower it and I wouldn't narrow it. As for M3, that aggregate always grows at a rate close to 9-1/2 percent, so it is ridiculous to try to do something else with it. It seems to me that we might as well face the reality and put those numbers up to 6-1/2 to 9-1/2 percent and know that it's going to be at the top of the range and may be a bit over it. I think we have troubles ahead. I hope that they will be met with as much flexibility and as much openness as we've done this past year. I would stay with these targets but raise the M3 numbers.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. I would join with those who see trouble ahead, but I don't think 1985 is going to be the critical year; I think 1984 is. If we were to get through 1984 with an outcome on the price side no worse than what the staff is forecasting, then we would be in reasonably good shape going into 1985. But, as I said yesterday, I think the risks are all on the up side. I think we're probably going to see somewhat stronger growth and more pickup in the inflation rate. And if we let that genie get out of the bottle in 1984, it is going to be awfully hard to put the cork back on in 1985. I can live with these targets or I could live with a somewhat lower range for both M1 and M2. But I want to remind the Committee how far these are from the kinds of ranges one would have to adopt ultimately if one were going to get price stability. If, for example, we interpret price stability as being something like 1 to 2 percent--the rate of increase we saw in the early 1960s--that allows 2-1/2 to 3 percent for potential growth of real GNP. Hack off 1-1/2 percent for a trend increase in velocity not related to interest rates and we are talking about 2-1/2 to 3-1/2 percent for growth of M1 and maybe 1 percentage point more or so for growth of M2. So, we're a long, long way from where we're going to have to be if we're really serious about getting the inflation rate down. And if we're not serious about getting the inflation rate down, we ought to decide that and adopt a course of policy in accordance with that view--for next year, I think.

CHAIRMAN VOLCKER. Are you serious?

MR. GRAMLEY. Over the long run, yes.

CHAIRMAN VOLCKER. For 1984?

MR. GRAMLEY. Oh no, not for 1984. I think we have to be pragmatic. We have an inherited inflation rate so what we have to strive for is to do no worse than see a tiny bit of acceleration of inflation along the lines the staff is forecasting, and then see if we can do a little better in 1985. But if we let inflation get considerably worse in 1984, then in 1985 it's going to get worse still.

For reasons I talked about yesterday, I think that M2 ought to be our principal target. The relationship between M1 and GNP may tend to reestablish itself on a more stable basis than we've seen recently, but I'd like to wait for that to happen. As far as targets for '85 are concerned, I would not be inclined to put out any numbers. I would like to see us make qualitative statements to the effect that we will attempt over time to bring down the rate of growth of money for reasons having to do with bringing down the rate of inflation, not as an end product in itself. But I think we ought to put out some warnings that we're serious about this business. And if we're not, we ought to tell the public that also.

VICE CHAIRMAN SOLOMON. What would you expect to happen in the real economy in '85 if we made a significant cut in the money target for '85 and the Congress had not or was not taking any action on the fiscal side? I'm not necessarily disagreeing with you. It's not a provocative question; I'm just asking what your honest guess is. Would we have a recession in '85?

MR. GRAMLEY. Well, I have never believed that one can find macroeconomic reasons for thinking that fiscal stimulus and monetary restraint are enough to push the economy into recession. Fiscal stimulus unleashes economic expansion; monetary restraint holds it back. And it's the balance between the two that determines whether or not the economy grows and whether we have more inflation or less. I think the main problems are on the micro side. They have to do with the damage high real interest rates create in the international area, to the thrifts, to the rate of business investment, and that sort of thing. I wouldn't be inclined necessarily to say that a continuation of current fiscal policy--that is, the current services projection of the growing deficit--together with more monetary restraint would push us off the cliff into recession. It sure as heck would create a lot damage.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. Well, I think we are having a lot of discussion about a world that we would like to see rather than the world that we're actually in. The idea of gradual reductions in money [growth] over time that will bring down inflation neatly and avoid recession is a world we wish we were in. In reality we bring inflation down through recessions. That's where progress has come in the past and I suspect that's where it will come in the future. If we're talking about further reductions in inflation over the next several years, then I think we're talking about a recession. It's not that we like recession, but it seems to me that the two go hand in hand. Having said that, I think we still have to be somewhat idealistic and put out the message of lower growth in the aggregates, but I don't think we really ought to kid ourselves. As far as the strategy in 1984 is concerned, I think we ought to continue to look at a number of variables and be cautious of any particular one. I think M1 is still largely unpredictable and has an unpredictable link with GNP. Some case can be made that it may not be as unpredictable as it was in 1983, but I don't see any evidence that would [warrant] elevating it to the premier status it once had. I think there is some case for giving it somewhat more equal status but I would prefer to keep it in a monitoring status, largely for tactical reasons. There has been some weaning of the market from this variable. I don't think it's as much of a shrine as it once was and that is helpful in this judgmental world that we have for monetary policy. So, I would keep M2 and M3 as the targets and M1 as a monitoring range.

As far as the specific numbers, I don't have a real quarrel with the specifications that we set in July, although I think Nancy is quite right that M3 grows at 9-1/2 percent whether we like it or not and we simply ought to realize that and at least have 9-1/2 percent be within the range. As far as M1 goes, I think a real issue is how much M1 is like the old M2. To the extent that it is more like the old M2, then I think higher growth rates are more acceptable, so that a range of 4 to 8 percent does not disturb me. I think we do have an M1 today that looks more like the old M2 with its implications for velocity. Now, I like the idea that has been put forth by several people for 1985--that we ought not talk about just one kind of outlook--because I don't think a [forecast] for 1985 by this group or any other group is worth very much. I think it would be a very good vehicle for underscoring the importance of doing something about the deficit or not doing something about the deficit and I would take that as its main objective. To have at least a couple of outcomes--one in which we get some help from the fiscal side and one in which we don't--I think could serve a positive purpose.

CHAIRMAN VOLCKER. Mr. Roberts.

MR. ROBERTS. Well, Mr. Chairman, with respect to 1985 or any longer-term period, I would be very cautious about expressing specific mathematical ranges unless we were required to do that by the Congress. I would rather see us have a qualitative objective, which is to reduce inflation steadily until we've eliminated it eventually over whatever period that might encompass.

As for 1984, I think the 4 to 8 percent range, in view of what is developing on M1, is probably too wide. I would be inclined to say 4 to 7 percent, except that for whatever reasons our directed growth of M1 has tended to be to the lower end of the range rather than otherwise. So, because of that tendency, I would be inclined to say 5 to 8 percent, raising the bottom figure. My reason is that I'm concerned about the recent slowdown that we've had in M1, as I said yesterday, whether measured as 13 percent in the first half and 5 percent in the second half or measured as 4 to 5 months, essentially, of no growth. In terms of the leads here, I think we have a probable slowdown in the economy in the second and third quarters already built in; and because of the surge in money late last year and earlier this year, I think we have an increase in inflation built in late next year or early in 1985. And I don't want us to be like the businessmen I refer to who extrapolate the present and fight the ebullience of the economy right now. I would rather see us get M1 growing again at a moderate pace. Alternative B, which essentially suggests about a 6 percent [M1 growth] pattern, is acceptable to me; it may be slightly on the high side, but I think unless we get that going we will have a cost in terms of real output in 1984 and we should not be sanguine about 1984. I would like to see us accept the fact that the aberration in velocity caused by a recession, lower inflation, and lower interest rates on these new deposit accounts may now be ending. We see a sharp rise in velocity here in the fourth quarter. I think we should get onto a trend line assumption of velocity, since it clearly can't be predicted in the short run, and build our money growth rates around that. If you accept that as on the order of 3 percent, then the 6 percent accommodates the 9 percent nominal GNP. So, I would like to see us remove M1 from the so-called monitoring range [status] since it really is the one variable that we can control most directly. I'd place it at least equal with the other aggregates and preferably give it primary status. More importantly, I'd like to see us do something to get it growing again. We have a forecast of 8 percent in December but we've had forecasts of increases for month after month that haven't materialized. I note that we have been decreasing reserves in November and December and it seems to me that's an expected result of that type of policy.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. I can't remember the exact words we used when we announced the preliminary targets for 1984 but I have a hunch that the words we used suggested that the reduction in the ranges was consistent with our long-term program to reduce the level of price inflation, and at this point I really don't see that we have a basis for changing them [again]. To make a significant downward reduction in the ranges would imply a higher level of restraint than we would want to have in mind. To increase them by any magnitude would indicate a very fundamental shift in policy, which I think would be a big mistake. So, I would be inclined to go with the ranges as we have announced them. For the reasons that Steve has suggested and that Governor Teeters has suggested, I would be inclined perhaps to reverse the ranges for M2 and M3. But I would at this point place a much higher reliance on M1. I think we should put more emphasis on M1 and that particularly relates to the conversation we had with regard to CRR yesterday. In light of the timing involved, we are getting to a point where CRR is going to come into place pretty rapidly, and perhaps we should begin to [increase the focus on M1] as soon as today when we talk about the intermeeting targets.

Regarding 1985, I think it's far too early to be specific about what we would suggest by way of ranges for the year but I think we want to continue to emphasize the long-range program we have in mind. I certainly wouldn't give Congress any reason not to deal with the fiscal problem and I would not in any way suggest that if they don't deal with it, we will have to back off on our objective for 1985. I would say that we have every intention of continuing the program and that we will continue to reduce the ranges, but I wouldn't be specific with regard to amounts this far in advance of the year.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I join those who would not want to make quantitative announcements as to 1985. But I also would like to see us maybe quantify the time that we're looking forward to moving toward price stability; I'm talking about a 5- or 6-year program with a gradual reduction over that period of time, yet accommodating what may be happening in the real economy. It seems to me that we have since 1971 or 1972 continued to say that we are moving toward price stability by reducing the money supply gradually over time. But there has never been a program set forth by this group that I know of in which people could look and find a result at the end or light at the end of the tunnel. If we were talking in terms of a rather specific program in the sense of an horizon over which to reach price stability--whatever that may be, whether it's 1 or 2 percent or zero--then it seems to me that we could work into that kind of public discussion what the likely outcome would be if nothing is done about the budget deficit. At this point to quantify targets for money growth for 1985 seems to me to be far in advance of anything we could predict. But in a longer-term picture it's [quite] reasonable to assume that there will be less money growth in '85 than '84 by some amount.

With regard to the 1984 ranges proposed in the Bluebook that were set tentatively in July, I have no problem with the M1 range of 4 to 8 percent. As a matter of fact, I take a little comfort from that 4 percentage point spread in the range. As for M2 and M3, I would probably opt to drop M2 to the same range of 6 to 9 percent [shown for M3] in the Bluebook. My reason for that, as has been stated around the table before, is that it is inconsistent to have an M2 range that's greater than the M3 range. And it's very difficult to explain that M3 is lower than M2 simply because we hope to fund some of the credit needs through Eurodollars, which also implies a continuing strength in the dollar and assumes further that European countries and other developed nations would continue to be operating at a very low rate of economic growth. That is a picture that I think we can avoid, whether it be true or not, simply by making the M2 and M3 ranges consistent with each other. And I would opt to have them at 6 to 9 percent.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. I'm fairly optimistic. As I said yesterday, I think 1984 will be okay as a year. I don't really think that it's going to be as vigorous as Lyle, for example, has suggested. I also don't think it's going to be as weak as I suggested it could be yesterday--

MR. MARTIN. Christmas is over already?

MR. PARTEE. --in the particular configuration that I was working out. I'm not greatly concerned about 9 percent as a nominal GNP number fourth quarter-to-fourth quarter. I think it's one we can key on. So far as I can see, the figures that the staff has given us are pretty consistent with about a 9 percent GNP number. So, I think the target growth rates as specified for 1984 are in the ballpark. But we ought to do this in terms of what we think would produce or would be consistent with about a 9 percent GNP growth.

Regardless of what happens next year, though, I really do think 1985 is going to be more of a problem. It will be the third year of a recovery--if the recovery lasts all year. And that's a recovery that is getting pretty old; it's getting to the time when the inflationary pressures get greater. It certainly is going to be a time when pressures in credit markets ought to grow because of the increasing private demand. And I would agree with Lyle that the role of the deficit in that really is to affect credit market conditions more than it is to affect the economy as a whole, which has pluses and minuses from fiscal policy but may in the short run at least be about offsetting. So, if we see the year of 1985 developing as one in which we may have credit-crunch type conditions--and that is generally now being forecast in the market--do we want to say that we're going to reduce our growth rates for the aggregates because we have some concept of a long-run non-inflationary environment, and thus ensure that there will be a credit crunch in 1985? I doubt that we want to say that. So, I would avoid a specific number for 1985 for that reason, because we do want to give as much encouragement as possible to the hope that there might be some fiscal action before 1985 is over. Again, it seems extremely unlikely that there will be any big fiscal move taking effect in the first part of '85; it might take effect in the spring or the summer of '85. When we don't know what the timing would be, even if there is any fiscal policy action--except that it seems unlikely that it would be at the very beginning of the year--that makes it extremely difficult to state any kind of policy tradeoff. So, I wouldn't specify anything for '85.

I think M1 has done quite a lot better than some people around the table give it credit for. But in this period it's certainly true that it doesn't look [consistent with] the GNP number, but that's because it doesn't have the stability characteristics that M2 or M3 or total credit have and that make them glide along at a more normative number that isn't too far, usually, from the GNP number. But I think that the performance of M1 has not been that bad and has been more indicative of what is going to happen in the economy than anything that M2 has shown over the last couple of years. I was going to say, Nancy, that M2 is 9 percent every year, good or bad, but you already said M3 is 9-1/2 percent regardless. So, I can't say that except that it seems to me also true. M2, by the way, I think shouldn't show the decline in velocity characteristic of earlier periods when we've had disintermediation because, after all, 80 to 90 percent of the total is now interest sensitive. And I think the [depository] institutions will be very competitive in the rates they offer as credit demands increase. They certainly will try to keep the flows coming in and, therefore, I think we could expect that M2 will show even more stability than it has shown in the past as the institutions operate on M2 as they have operated on M3 in the past--and that is to be a source of funding. So, I would give more status to M1. I would adopt the staff's proposals, which I guess are pretty much the same as we had set in a preliminary way last July. And I would be quiet about specific numbers for 1985.

One other point: I want to agree with Ed Boehne in that I don't think we can expect to make progress every year on the rate of inflation anyhow. I think we have to look at it as a full cycle process. And if we can keep the inflation rate from accelerating much beyond 5 percent, or certainly keep it from accelerating beyond 6 percent in the course of this cycle, then we can go down to zero in the next recession. And we'll have a much better posture for having a much less inflationary cycle the next time around. But I don't think it's reasonable to say we have a 4-1/2 percent inflation forecast for next year and in 1985 we'll bring it down to 4 percent and in 1986 to 3-1/2 percent and in 1987 to 3 percent. We just can't do that. The dynamics of the economy won't permit it.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Mr. Chairman, I think the concept of price stability should be the overriding objective. And having said that, I think whatever words we use for 1985 obviously should reflect that. I also would not want to use specific numbers. But it does seem to me that the targeting for 1984 comes at a very critical juncture, certainly in terms of credibility. We have said that we will bring inflation down through a gradual reduction in the growth rate of money. In order to solidify that position and make it believable, I would be inclined to bring the M1 range down more in line with what Bob Black was suggesting, possibly to 3 to 7 percent. I think that would be a very clear signal that we do remain committed. I happen to be willing to put more emphasis on M1, and I think it is more believable, and thus that it would be positive to do that. I think that [range] would also be consistent with enough [M1 growth] for the 9 percent nominal GNP growth. On the M2 range, I would be inclined to shade it down to 6 to 9 percent since the 6-1/2 and 9-1/2 percent doesn't represent any real reduction. And on M3, I would probably go back to the 6-1/2 to 9-1/2 percent because its growth just always is 9-1/2 percent. It seems to me that would give a better picture. But I would argue very strongly for shading down the M1 target for 1984.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Mr. Chairman, I agree with almost everything Governor Teeters said. I'm just not able to look much beyond 1984 and, therefore, I'm unable to say anything specific about 1985. I would just like to be able to say in general terms that we hope that things develop in 1984 in such a way that we can continue to move in the direction of price stability in 1985.

As for 1984, I think that our tentative target ranges are realistic--that is, they are consistent with the staff forecast and with what I expect to happen, with the exception mentioned by Nancy that the M3 range could and should be raised in order to avoid the possibility of squeezing. So, with the exception of that minor change of raising the M3 range by 1/2 percentage point, I think these ranges are good, satisfactory, and realistic. I think we should reiterate in very strong terms our commitment to long-run price stability. And I think it's important that we demonstrate that commitment by the targets that we select, which we've done in this case. We've reduced the ranges for 2 out of 3 and if we can continue to do that, the inflationary expectations will be affected in a manner that would be positive from my point of view. So, I'm satisfied with the target ranges presented except for M3. And incidentally, I'm also encouraged by the recent behavior of M1 velocity. But I'm not yet ready to resurrect M1 to full target status. I would like to watch it for a while longer. Perhaps in July we might consider that restoration.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. Sometimes, Mr. Chairman, it helps to get outside of one's own group and kick around these kinds of problems with a few knowledgeable outsiders, which we did at our Bank earlier this month at a conference on monetary targeting and velocity. That was held in view of the major, unprecedented decline in velocity in '82. I'm just going to give a few highlights that I think may be of interest to this group. A number of people who are in the room were at that conference or participated in it, including Steve, who was our lead-off speaker, and Frank, who chaired the panel. I made some remarks and we had some professors making remarks and so forth. One of the things that I found particularly interesting about that meeting was a comment by an official of the Bank of Japan who looked at what was happening in monetary targeting across a number of countries in different parts of the world. Very briefly, he concluded that in those countries where regulations--especially on deposit interest rates--have been binding, the financial innovations [aimed at] getting around those regulations had a really major distorting effect on the various monetary aggregates used in those countries. On the other hand, he set forth a class of countries that had deregulated in the face of rising inflation and interest rates and found that there had been much less distortion in the monetary aggregates in those countries. I found that cross-country analysis really quite interesting because it seemed to me to be consistent with the U.S. experience. In particular, in our own country we look back at 1974 and 1975 when there was a great deal of financial innovation, if you remember, [to get] around the regulatory ceilings on interest rates. M1 was badly distorted. There is no doubt that that was about the time that I became a proponent of M2, but of the M2 of that day. But in this more recent period of 1982 and 1983 when, as you know, we had considerable deregulation and it was proceeding quite rapidly, it's our view in San Francisco at least that M1 was quite little distorted on balance. The big distortions, to our surprise in a way because we expected the opposite, came in M2 and in M3.

Another thing, as far as I'm concerned, that came out of that conference was something of a compromise point of view, I guess, on what did happen to M1 during that period in 1982 when its velocity was dropping by an unprecedented amount. When everything is said and done there really have been two basic explanations here and among the academics as to what was going on. Perhaps this is a bit oversimplified, but one explanation is that it was a business cycle phenomenon--the build-up of precautionary balances and that sort thing, which in turn caused velocity to decline. The alternative view, which we lean toward in San Francisco, is that the big drop in velocity was a direct response to the major decline in the rate of inflation and hence the major decline that occurred in market interest rates in the latter half of 1982--that that in effect caused the opportunity cost of holding money to drop sharply and led to not a shift in the demand for money but an increase along a given demand function in the amount of money that people wanted to hold in relation to income. Well, whichever one of those explanations might eventually win men's minds or whichever of those explanations is true, the real point, as I thought about the conference and its aftermath, is that the phenomena to which they were referring are over. That is, the recession is over; we're coming out of it. We don't expect another big drop in inflation and interest rates, as much as I would like to see that--something that could cause velocity to drop. I don't see a decrease in the amount of money demanded on the horizon either. But that reinforces my belief that we're well on the way toward [returning to] the more normal behavior of M1 that we had historically.

In view of that background, I come out bottom line in much the same way that Messrs. Black, Roberts, Keehn, and Partee have here. I would restore M1 to more importance, perhaps even primary importance. I have to say that I'm getting a little nervous about our credibility being undermined in the academic community and among serious students of money and monetary policy by our continuing officially to set M2 and M3 targets because they know as well as we do what some have already mentioned around the table here: that M2 and M3 go on like Old Man River at about the same rates of growth almost irrespective of whether the economy is in a strong upswing or whether it is in fact in the middle of a recession. I'm not against having some extra targets we're almost bound to hit. The best thing I can say about M2 and M3 in terms of keeping them as targets is that they're almost impossible to miss. I guess that's not without some merit compared to a target that jumps around. But, frankly, I wouldn't give very much weight to them. I think the more we continue to do so the more we're going to undermine our credibility out there where it counts, or at least in some areas where it counts.

Specifically, I would go in the direction that was implied in the Bluebook that perhaps it's time to reduce the spread of the M1 range from the 4 points that we now have. You all recall that many years ago a spread of 2 points was par for the course. I don't think we need to jump down that far that fast, but I would urge consideration of reducing that spread to 3 points. At this time I don't believe we're trying to make final decisions, Mr. Chairman, but certainly I would not at this moment want to see that 3-point spread centered any higher than 6 percent and might even favor aiming at a 5 percent midpoint. If we're going to have a 6 percent midpoint, which is about the most I would go for, we could consider a range of 4-1/2 to 7-1/2 percent, if we were willing to adopt only a 3-point range rather than a 4-point range. It's not without precedent that we have ranges that have a fraction of a half. We did that just a couple of years back, so that wouldn't be a particularly troublesome innovation. In terms of M2 and M3, I guess I really don't care. I could take what is in the Bluebook or some of the modifications that [have been suggested] here because I don't think they mean much. They don't indicate what is going to happen in the economy; we have very little control over them. So, for all the reasons that I've talked about today and that others have talked about, and in light of the paper I circulated to you a couple of months back, I think the time has come to restore M1 to at least equal weight, if not more.

CHAIRMAN VOLCKER. Nobody has suggested we go on the gold standard!

MR. BALLES. Not yet.

CHAIRMAN VOLCKER. [Unintelligible] not happy with all these Ms.

MR. WALLICH. We might consider targeting the exchange rate.

VICE CHAIRMAN SOLOMON. Yes, but in practice we don't vote that way. What would you do right now? Would you ease monetary policy?

MR. WALLICH. One would have to ease, and that is why it's not a good idea.

MR. MARTIN. On the gold standard we would have to ease, Henry.

CHAIRMAN VOLCKER. You don't want to defend this proposition?

MR. WALLICH. No, the theoretical point is that the exchange rate should carry some weight along with total credit. I'm not saying that we should do what the Canadians do now.

CHAIRMAN VOLCKER. It's working pretty well, isn't it?

MR. WALLICH. It works pretty well. It would at the present exchange rates; we wouldn't want to stabilize those.

CHAIRMAN VOLCKER. Why don't we turn to Mr. Cross?

MR. CROSS. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Any comments or questions?

MR. BOEHNE. This isn't just addressed to Sam, but maybe also to Henry or Tony. Do we know of other experiences, say in the post World War II period, where a major currency has gone in the opposite direction that the current account would say it ought to go for such a prolonged period and by such a large amount?

VICE CHAIRMAN SOLOMON. No. I don't know of any this large. But there certainly are lags; these things don't correspond exactly. And it's really the reversal in direction that is usually most picked up by the markets when they are looking at some [unintelligible]. In 1978 when the dollar was sinking one reason we felt that we could probably undertake a major intervention that would stick--and we did it in November '78--was because the current account deficit was no longer increasing and indeed was beginning to shrink in response to the more competitive dollar that we had in the year-and-a-half before that. So, I don't know of any such situation; in fact, there's no question about it. These numbers are so huge now that there's nothing comparable. The largest current account deficit that we ran in the late '70s was in the neighborhood of $15 billion. We're looking next year at a deficit of probably $80 billion. And there is no other industrialized country that has run a deficit of more than $15 to $18 billion.

MR. BOEHNE. It's as if we're skating on a frozen lake and we just keep skating and we know we're going to get to the point where the ice isn't very thick out there.

VICE CHAIRMAN SOLOMON. I don't think it's a sustainable situation in the long run. One can make an argument that it's not a time bomb--that when the dollar comes off it will come off gradually and moderately. I don't believe that. I believe that the longer it goes up and stays up, the faster it will come down when expectations change. What I don't have any feeling for is the comment that I frequently hear--and I think Henry said this--that when the inflow of dollars stops because of the change in expectations about the exchange rate, that is going to have a very major upward effect on our interest rates. I'm not sure that that's so. I don't know what the interest rate effect of that will be because it is sometimes argued that the banks can bring enough back in the Eurodollar market that we wouldn't get that much of a movement in interest rates. I don't know whether Paul has a view on that. We may end up with just a very big impact on the exchange rate and a very minor impact on interest rates from the cessation of the inflow of foreign funds. What do you think, Paul?

CHAIRMAN VOLCKER. I think it's a danger.

VICE CHAIRMAN SOLOMON. The interest rates?

CHAIRMAN VOLCKER. On both sides.

MR. WALLICH. Is the result the cessation of capital imports? Capital imports can't cease overnight, of course, because our exports aren't going to go up overnight and imports aren't going to go down.

CHAIRMAN VOLCKER. No.

MR. WALLICH. So in that sense while we unwind this $80 to $100 billion current account deficit we will have upward pressure on interest rates all the time but not the full pressures at the beginning of the process.

MS. TEETERS. I might also add that the Europeans have the attitude that the dollar is going to drop sharply at some point. They are as much confused as we are as to why it hasn't dropped [already]. But their real concern is that they perceive that [drop] as a sharp appreciation of the D-mark. They are very upset about the implications of a sharply appreciating D-mark in the European Monetary System because there is no way to foretell what the relationships of the other currencies to an appreciated D-mark would be.

VICE CHAIRMAN SOLOMON. At a minimum it probably will force much more rapid devaluations of the weaker currencies in the EMS. And it might even make it almost intolerable, depending on the Italian and French policies. It certainly will mean much more strain on the EMS.

MR. TRUMAN. The answer to President Boehne's original question is that there certainly are other examples. We have the Japanese at the moment. They have had a very strong current account and a relatively weak [currency]--at least relative to the dollar experience. We've had the British experience. I'm not sure exactly which way the British current account [is going now], but certainly in the early Thatcher days sterling was very strong and the current account was pretty good because of oil. But it was a period when the currency was moving in an unsustainable direction in the absence of [unintelligible] of the current account. It subsequently has reversed.

MR. ROBERTS. It was fascinating to read in the paper this morning that the OPEC countries have a $31 billion deficit.

VICE CHAIRMAN SOLOMON. Everybody has deficits.

MR. ROBERTS. But the OPEC world, remember, was going to end with a $100 billion surplus.

MR. WALLICH. The sum of the deficits is $100 billion in excess of the sum of the surpluses.

CHAIRMAN VOLCKER. Any other questions or comments?

MS. TEETERS. I have one other question about intervention. What makes you decide when to intervene? What is the trigger? Is it a certain degree of movement in the rates, or what, that triggers this?

MR. CROSS. No. We keep getting asked this question over and over. What happens actually is that, of course, we are monitoring [the market] all the time. When we see a situation where it looks as if rates could be moving too rapidly or are very volatile--kind of gaping, with one transaction here and then the next buy or sell order moving out of the range entirely--or just generally unsettled conditions in the market, then we talk to our colleagues at the Board and our colleagues at the Treasury. And usually at very, very high levels in the Treasury Department there's a decision as to whether they feel that it is or is not a disorderly market. Certainly, one of the factors that goes into their thinking is the attitude of some of the other monetary authorities. On the occasion when we intervened in December [our action] followed some intervention by the Bundesbank--indeed some intervention where the Bundesbank had come in at the end of their day and intervened in a way that was going to affect the DM in our market. They had called us up to tell us about it and to see if we had any concerns about it and we decided, again after consultations, that it would be appropriate for us to go in. But we intervened in a modest way. These have all been very modest transactions; $50 million worth of DM, at a time when the market is as big and as active as it is, is not going to reshape the world.

VICE CHAIRMAN SOLOMON. In fact, there is a Machiavellian theory which, of course, nobody here subscribes to: You can argue that intervention in this penny ante amount is simply a way of discrediting intervention as a policy.

MR. CROSS. It shows some evidence of being willing to participate but in a very modest way. And I don't think anybody thinks that these amounts have any great impact. It can temporarily settle a situation if we do enough of it.

MR. WALLICH. How often did the Bundesbank operate in New York directly?

MR. CROSS. On one occasion. This was a very unusual situation in which the dollar was moving at a very, very rapid rate just at the time our market was opening, and they did intervene on that occasion in the amount of about $500 million. Subsequently, they have intervened in the market through the New York Fed, with us acting as agent.

MR. WALLICH. How often did they do that, more or less?

MR. CROSS. Once or twice--not often.

MR. RICE. Do we have any problem with their coming into the New York market and operating there?

MR. CROSS. Well, we like to know what other central banks are doing in our market.

MR. RICE. So long as we know.

MR. CROSS. For a number of the central banks--the Japanese, the Swiss--when they do, which is very rare, we act on their behalf. And that to me is the best way to handle it. Then we can do the operation for them and know what is happening and handle it. And the Germans did operate that way subsequent to this one occasion when they acted directly; they were trying to make a big splash and to show the world that they were out there selling all these dollars.

MR. RICE. We prefer to have them do it through us?

MR. CROSS. I do.

MR. WALLICH. Peter, could I ask you: Is it right to say that that $50 million peanuts was sterilized automatically the same day or the next day?

MR. STERNLIGHT. Probably for the reserve effect it would be a couple of days later; it was folded into all the other reserve factors that we take account of.

MR. WALLICH. But you wouldn't have done anything on that day, I suppose, if you hadn't been planning to do something anyway?

MR. STERNLIGHT. No. There wouldn't have been an immediate reserve impact anyway. But we would have acted as soon as we had the information and folded it into all the other reserve factors.

MR. CROSS. We settled two days later anyhow.

MR. GUFFEY. I'm told that the Russians have been very active in foreign exchange markets, acquiring dollars. I'd just like to ask

Sam how much of the rise in the dollar value vis-a-vis the mark, for example, can be attributed to those apparently rather substantial activities by the Russians?

MR. CROSS. Well, it's very hard to say. Certainly, they have been active, particularly in the past couple of weeks, in buying dollars. For what reason, I don't know. We have been trying to keep a log of what we hear and find out about their activities to see if we can figure out what their approach is. But in the past couple of weeks they have been buying very heavily in the dollar. And, as I mentioned, the Bundesbank has done really quite a large amount of dollar sales--over $1-1/2 billion. The Russians have been buying a very large chunk of this on the other side, we think. One thought is that they have some big year-end dollar needs, just as many others have big year-end dollar needs. But I don't really have a good explanation as to why they're doing it. They seem to be buying a lot of dollars and selling some sterling, for example. Earlier this year they were operating on different sides of the market. We're trying to get a better assessment of their approach, but right now we really don't know what their purpose is in buying dollars. But they have been buying them heavily in Europe, in New York, and in the Far East.

MR. KEEHN. Paul, are you going to cover later the current status of the various external financing packages of Brazil, etc.?

CHAIRMAN VOLCKER. I thought maybe we could do that after the meeting [at lunch]. Meanwhile, we have to ratify these transactions.

MS. TEETERS. I move that we ratify the transactions.

VICE CHAIRMAN SOLOMON. Second.

CHAIRMAN VOLCKER. Without objection. Mr. Sternlight.

MR. STERNLIGHT. [Statement--see Appendix.] That concludes my report on operations, Mr. Chairman. I do have a recommendation about leeway for the next period. Specifically, I think it would be advisable to retain the $5 billion intermeeting leeway for changes in outright holdings that was adopted at the last meeting. The difference is that this time the enlargement would be needed to cope with seasonal declines in currency and deposit levels. Also, if the intermeeting period extends into early February, we would come up to that final phase-down step of reserve requirement ratios for member banks coming out of the Monetary Control Act. That's all I have, Mr. Chairman.

CHAIRMAN VOLCKER. Comments or questions? In view of great silence, we can ratify the transactions.

MR. PARTEE. So moved.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. Without objection. The leeway question?

MS. TEETERS. So moved.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. Without objection. Mr. Axilrod.

MR. AXILROD. Mr. Chairman, my briefing will focus on M1--not because I want to overstress it, but because M1 is the aggregate recently showing the most variable behavior relative to norms, so to speak. That's what is perhaps most in need of analysis, particularly since in the recent past its variations over a period of months have often provided good signals to follow. [Statement--see Appendix.]

MR. BLACK. Could I ask just one brief question, Mr. Chairman? On your experimental weekly M1 seasonal, Steve, do you have a figure for December? I gather it would be not too far off from--

MR. AXILROD. Yes, for December [in] the regular series we have 2.3 percent, a drop from 6.7 percent in November. That compares with our projection of 8.1 percent. So, there is a big difference in seasonals in November and December.

MR. BLACK. Only 2.3 percent in December?

MR. AXILROD. Yes, it's about a 5-1/2 or 6 point difference. There's a very big seasonal. The seasonals, month-to-month, are very different, as you can see in the series.

CHAIRMAN VOLCKER. Well, we might as well have a doughnut.

[Coffee break]

CHAIRMAN VOLCKER. I don't know if anybody else wants to direct any questions to Mr. Axilrod.

MR. CORRIGAN. I just have one, Steve. Is it a reasonable proposition to you and Peter to say that where you think you are now in the borrowings is $650 million?

MR. STERNLIGHT. That's the objective, yes. Some weeks come in above and some weeks below.

CHAIRMAN VOLCKER. That was a pretty erratic intermeeting period in terms of where the borrowing and the net borrowed reserves came out. The average is not too bad over six weeks or so; it is not too good [in relation to the intended level] in between.

We have already had quite a lot of discussion--by implication but not in precise terms--of where we should go in the short run. I might say: The housing starts figures came out this morning. Just to get that on the table, Mr. Kichline, can you describe those?

MR. KICHLINE. Yes. In November, housing starts rose 100,000 to 1-3/4 quarter million units, annual rate, from an upward revised level in October. Both single-family and multifamily starts rose in all regions in the country, mostly in the West. Permits also rose a little and the permits for October were revised up a little as well.

CHAIRMAN VOLCKER. Yes, permits did not rise very much. I do not know if this is terribly significant, but the flash GNP will be coming out this afternoon--no, it won't be out until tomorrow. I do not know what it is, but there is a suspicion in other places that it may be a little higher than our staff has projected. But I do not know for sure.

MS. TEETERS. It's not a very good number.

CHAIRMAN VOLCKER. It's not even a very good number in my opinion after it is no longer the flash. Unfortunately, it can be inaccurate in both directions. But it will be a pretty strong memory.

I suspect we are getting a little seasonal pressure in the markets. I think [whether or not] the reserve positions change, one would expect seasonal pressures from the middle of December probably through the end of the year. We [typically] have a very erratic--or maybe [simply] erratic--money number early in December; nobody knows quite what is going to happen through the first week or two of January when we have often had very erratic numbers. This is well reflected in the quite different signals that our two seasonal adjustment techniques provide. In trying to sort all of this out, and just to give you something to aim at: Given the strength of economic activity--until there's a little more evidence that it is going the other way, if we ever get it--given the nervousness of the inflationary expectations, and given that the latest money supply figures look a little higher anyway, I don't find myself in any mood to ease. I am talking about a very short time perspective of several weeks. Whether one would want to tighten up slightly is debatable, I suppose. Part of my problem with tightening is that in announcing it, as we inevitably would have to do sooner or later, [the announcement] may exaggerate whatever one's intention was, unless one had a pretty strong intention. I find myself in a position where I think that maybe what we can say is that we will maintain the existing degree of restraint at least for the time being and if things turn out to be on the ebullient side, economically and with the aggregates, we could make a small tightening move in coming weeks or wait for a little more evidence. That is the way I would tend to write the directive--in a sort of one-sided way.

MS. TEETERS. Well, the end of the year is going to place some upward pressure in the market area anyway, isn't it?

CHAIRMAN VOLCKER. Well, I don't know whether it will be more than what we have, but I would think that if we maintain this for the next week or 10-day period maybe, it might remain under some pressure both because of seasonal pressures and because the Treasury is doing a lot of financing between Christmas and New Year's Day. Then I think that seasonal [pressure] would be over.

MR. STERNLIGHT. I think the pressures may linger a day or two [longer].

CHAIRMAN VOLCKER. Well, maybe into the first couple days in January--so, maybe [for the next] two weeks.

MR. ROBERTS. Paul, when you say you wouldn't ease, do you mean in terms of our current borrowing standard? You're not talking in terms, say, of looking at 2 percent money growth in the fourth quarter?

CHAIRMAN VOLCKER. I am talking about the borrowing assumption. And I am talking about, I presume, without being absolutely precise--we can discuss it--measuring the prospects for any tightening subsequently so far as the aggregates are concerned against the standard of something like "B."

VICE CHAIRMAN SOLOMON. This is halfway between existing policy and snugging up.

MR. ROBERTS. I think "B" is a liberalization of major magnitude, if we can get it done, as against what we have been doing.

CHAIRMAN VOLCKER. I haven't focused closely on those figures. I was thinking of something in that area, but we may want to lower or round some of those to whole percents. These figures for M2 and M3 are pretty close, I guess, to the staff's December projection; they don't involve any particular change in trend from what we have been having for M2 or M3. M1 would obviously be a little higher, but probably lower than--well, who knows what the December figure will be!

MR. GUFFEY. For purposes of this discussion, I would agree to adopting the "B" alternative as it appears in the Bluebook. In view of the discussion and the feeling about the potential for some reemergence of price pressures, I would opt to snug up marginally or have some nuance or whatever it may be of [snugging]. Rather than take a $650 million borrowing level, I'd go maybe to $750 million, which implies about 1/4 percent more [on the funds rate] than what we have been shooting at in the past. If I understand what has been said around the table, particularly from Peter, the pressures that are coming on because of technical matters at year-end might move us to a funds rate of 9-1/2 percent or a bit above. I am really suggesting that with a $750 million borrowing level we essentially would validate that level after the technical pressures subside and end up with something over 9-1/2 percent and certainly not greater than 9-3/4 percent. It would, in my view, present a picture that the Federal Reserve has some concerns about the strength of the economy and the potential for a reemergence of price pressures.

CHAIRMAN VOLCKER. I have just one comment on that. I don't think we can aim at the federal funds rate as closely as one quarter of 1 percentage point. We take our chances on that a bit.

MR. FORRESTAL. I came into the meeting feeling pretty strongly that any easing of policy would be a mistake. I have not heard anything in the last two days to change my mind on that score. By the same token, I don't think that any substantial tightening of policy is appropriate. The decision in my mind is whether we have a slight tightening of policy, something implied by "B" or "B-," I suppose one could say. What those numbers are, I am not quite sure. A $700 or $750 million borrowing level probably would be a degree of snugging rather than a tightening. I think there is a lot of merit in what you said about waiting to see what develops in the next week or so. So, I am happy with "B" or something slightly less than "B," moving a bit toward "C."

MR. GRAMLEY. Mr. Chairman, if we did not have these M1 numbers and were looking just at the real economy and what is going on, I think we would have moved long ago toward a posture of more restraint than we have now. I can understand people's concern about M1, but I think we have to recall that what we are looking at is a stock, not a supply; it is an intersection of demand and supply. We have to try to figure out where the weakness is coming from. One could well argue that it was coming from restraint on supply if we were seeing either a significant slowdown in the growth of nominal GNP or a rise in interest rates or both. None of those things is happening. Indeed, when the staff runs its model and tries to figure what money growth is taking place in the fourth quarter, consistent with the old relationships that we used to have between M1 and GNP based on the old standard M1 demand function and the econometric model, the answer is 8.3 percent. And I dare say that if we were looking at 8.3 percent growth of M1 in this quarter, given the history of very large growth for the last two years and the continuing tendency for the economy to far outrun our expectations, we would be moving toward restraint. I don't see any strong reason for waiting. I think we ought to begin moving now toward a tighter posture. I would opt, therefore, for something between "B" and "C." I might go even a little further than Roger--up to an $850 million borrowing level. I wouldn't want to see the fed funds rate go over 10 percent, but I wouldn't mind at all if it stayed in the 9-1/2 to 10 percent range.

MR. KEEHN. For the reasons that you outlined at the outset, I would be very much in favor of alternative B. Having said that, I would be in favor of modifying the directive, as I have suggested a couple of times so far, to indicate greater emphasis on M1. Also, it does occur to me that this [directive] will be coming out probably in late January or early February after we have embarked on a major operating change, and I think we ought to reflect that now. So, again, I'd change the directive. I'd leave the borrowing level at about $650 million, but I would change the fed funds range to 7 to 11 percent--not to indicate any policy change but simply to give us more room in which to operate, because I have a hunch that the funds rate, at least for the next few weeks, will rise pretty close to that 10 percent ceiling.

MR. WALLICH. I would go to $750 million on borrowing and I'd be quite satisfied with 8 percent growth of M2 and M3. And if that leads to 6 percent on M1, that would seem to me in line with the ranges that we are about to set, possibly. On the funds rate, I do not particularly want to see it higher, except marginally. But I think we have to have a little more room on the up side, if it's not going to be totally confining. So, I would say 6-1/2 to 10-1/2 percent.

MR. MARTIN. Mr. Chairman, I have observed that the unemployment rate, with the most recent data we have and the staff projections through 1984, brings us to a position well above the so-called natural rate of unemployment that we reviewed at the last FOMC meeting. Also, in contrast to some of my colleagues, I observe very, very little evidence of a reigniting of inflation. You cannot find it in commodity prices, in gold, or in the usual indices. If you accept the staff forecast quarter-by-quarter of the real GNP, it comes down nicely. One would wonder, as has been observed here previously, what better configuration of a moderation in economic expansion one would seek in contrast to what has been projected here. It seems to me that alternative B, which is essentially the status quo with a $650 million borrowing level, not $750 million, and with growth of the aggregates as indicated is consonant with an expansion period that is almost textbook. I would join my colleague Governor Rice in the hope that we could restore M1 to the pantheon on Olympus in July, having the ex post expertise that we all will acquire so readily in looking backward over [the intervening] period of time. I don't think this is a time to signal to a nervous market that we see inflation coming back when only the Wall Street gossip would join us in that expectation.

MR. BOEHNE. Well, I don't want to overstate what I'm about to say, but it seems to me that we have to rely to some extent on what we think is going to happen down the road, simply because of the lags involved. We can be wrong, however, about the future we see. Therefore, to some extent we have to ask ourselves which mistake is easier to undo if we make it. As I look out into 1984, it seems to me that it would be easier to undo a little too much restraint now. In other words, it would be easier to ease later in the year than it would be to tighten because we waited too long. I think the risks in the domestic economy are on the side of more growth than we expect, more inflation than we expect, and more accommodation on the part of monetary policy. So, for no other reason than just to curb a rather buoyant psychology out there, I think some very modest move toward tightening would be appropriate between now and the next meeting. The order of magnitude I would come down for is something like a "B-," with $750 million or so on borrowing. I think that such a modest move would get lost in the year-end churning that we're going through, so it seems to me that some time in January would be the appropriate time for the tightening to emerge.

MS. TEETERS. I think we need a period of continuous stability. My perception of the economy is that, yes, it has recovered in the typical fashion, but the recovery could be very easily upset with rising interest rates. I think we can afford to wait to see what is going on. I would add to my concerns that any upward movement in the interest rate is going to make the exchange rate worse. I agree with Tony that the more it goes up the harder it's going to fall--it's going to be rather precipitous--and that that would increase our problems of adjustment during 1984. So, I would simply take alternative B, the $650 million on borrowing, and the 6 to 10 percent funds rate range; I'd keep a fairly moderate stance at this point and let the year-end pressure do its thing but then come back out of it in the 9-1/2 percent range [on fed funds]. And we can readjust; the [next] meeting is not that far away. I would also point out to you that if we tighten now, the policy record from this meeting will be released probably on the day that the Chairman testifies.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Mr. Chairman, in terms of the strength of the economy, I think one could make an argument for some snugging up at this point in time. I think the evidence in housing is that that sector has adapted pretty well to the current level of rates. I don't think there is room in the economy, given the strength of the capital goods sector, for any substantial revival in the strength of housing. But at the same time I could accept alternative B as written or some snugging up; I don't feel a strong conviction as to which one is right.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. I think it's premature to tighten today. I agree with Pres and Nancy that the economy still has quite a lot of room in it--that we don't really have any signs of inflation except in the hype that the market is putting on the question. And it would be wrong to move in response to that. If we were closer to full utilization, we would have a little less tolerance to a mistake on the up side. I thought Ed Boehne was going to conclude that since our forecast is reasonable we shouldn't change policy. But he surprised me by saying that since the forecast is reasonable we ought to tighten up. I guess I don't agree with that unless unusual strength develops in the period ahead. That is, we can't really stand more surprises on the up side of our expectations; we could stand some surprises on the moderately lower side. So, I think your original proposal is a quite good one. I don't see why we ought to bias the result by starting out with a higher borrowed reserve figure than we have currently. I think we ought to put it in at $650 million or thereabouts and then if, in fact, things strengthen quite a bit in the weeks to come, we ought to let the borrowing run up with the strengthening that occurs. I would feel a good deal more willing to see some snugging if we could get some strength from M1. We haven't had it--except for last week--and I guess if we did get now a rather meaningful expansion in M1, that would be another signal that perhaps the economy was stronger and thus we ought to snug. So, I would do just as you suggested in the beginning, Paul, but with $650 million--I don't know that you spoke to the borrowing number--as the beginning borrowing number.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. Let me just add a point that I forgot to mention earlier. In terms of emphasis on the various aggregates, I too would put a little more emphasis on M1--not restoring it to its former grandeur but nevertheless putting a little more emphasis on it. Having said that, I would also add that I'm not sanguine that the market has learned its lesson. The relatively dispassionate reaction to M1 that we've seen over the past few months is nothing more than a reflection of the fact that M1 isn't anywhere near the top of the target; that is, people are more tolerant of its behavior.

As far as policy goes now, I am in the camp that says the bell has rung and recess is over and it's back to school. I've been there for some time. I do, therefore, favor a modest move now. I view something along the lines of what Roger said as satisfactory; but pending developments in the intermeeting period, I probably would be willing to go as far as Governor Gramley suggested. There are risks in that, certainly. I think the most pronounced ones are on the international side, with the exchange rate and the implications for the financing costs of developing countries. That is the single thing that gives me the most pause for concern and caution. As I said yesterday, I think we're by no means out of the woods in terms of domestic financial problems in a context of rising interest rates, which is one of the reasons I'd rather try to do a little something now in hopes of not having to do more later. Certainly, there are some political risks, particularly in a context in which M1 doesn't seem to be growing at a very robust rate based on our own numbers. But, again, I feel rather strongly that the risks on the other side are greater at this juncture; in my view at least, the economy and inflation may be more of a problem than others see it to be. I also agree with the thrust of Ed Boehne's remarks. If we do something of a modest nature now, it's pretty easy to reverse it if indeed events warrant that. On the other hand, if we don't do something now, I believe it becomes harder to do it later and I also believe we run the risk that we will have to do more later rather than less. So, I do my own balancing of these risks and I must say that I come out on the side of moving up now, say, to $750 million or maybe a bit more. And for the intermeeting period as a whole, pending developments, I probably would be willing to go further--certainly not above 10 percent on the federal funds rate, but if we had to go to 10 percent, I'd go to 10 percent.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. At the risk of being accused of looking at the hole rather than the doughnut, I would quickly like to repeat something I said last month--Chuck is smiling--that these [unintelligible] looking figures on the macroeconomic statistics are not capturing all of reality. My deputy chairman came back from a recent meeting of the Conference of Chairman and Deputies and according to his tabulations there were 6 to 9 Districts that reported distinctly spotty trends in the economy. Yes, indeed, a lot of things are going well. But a lot of things aren't going well, and they're concentrated in areas such as agriculture, export industries, and so on. So, on a broader basis, my own reading of the economy is that there is not really much risk of a major significant reacceleration of inflation. Therefore, I would come out similar to the way that Governors Martin and Teeters and Partee have come out. I think it would be premature to snug. I would be in favor of alternative B and would like to see that borrowing assumption no higher than $650 million. The hoped for turnaround in M1 is still a forecast, not a fact. And if it proved unfortunately not to be an accurate forecast, I would begin to get a little more worried than I was last month.

CHAIRMAN VOLCKER. Did you say you would like to see the borrowing above $650 million?

MR. BALLES(?). No. I said I would not like to see it any higher than $650 million as the initial figure.

CHAIRMAN VOLCKER. Mr. Solomon.

VICE CHAIRMAN SOLOMON. I think there's a difference, even though it's a nuance, between "B," retaining existing policy, and your proposal, Mr. Chairman. Since I indicated yesterday that I was torn between retaining existing policy and a very slight snugging up, I think your approach tries to bridge that. You said you would maintain at least the existing degree of restraint and you would have more restraint depending on the continued strength of economic recovery and you would drop out the section on lesser restraint so that the directive is somewhat asymmetric. Basically, that poises us to do some snugging but it doesn't actually do the snugging. We would stick with the $650 million for the time being but if we see continuing strength in the economic recovery, and particularly if that's reinforced by money numbers, then we would do the snugging up. I don't know--we wouldn't need a conference call then, would we, at that point? Based on that directive, that would permit some snugging up.

CHAIRMAN VOLCKER. We'd need one, I think, if we wanted to go the other way.

VICE CHAIRMAN SOLOMON. Right.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. I would align myself with those--I think Jerry Corrigan said it very well and others--who would start moving against [inflation] now with a $750 million initial borrowing assumption.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Mr. Chairman, I would support your original proposition whereby we hold our position where we are now and could apply more restraint if it seems necessary. So, I would support alternative B, borrowing at $650 million, and a funds rate roughly where it is now.

MR. ROBERTS. Mr. Chairman, although I'm concerned about the fact that we haven't been able to get M1 growing, I would be willing to accept the staff forecast for December and the 6 percent growth in the first quarter implied in alternative B and would accept your proposal of not increasing restraint at this time. Along with Mr. Balles, I would prefer that we make it very clear that if we don't get that expansion in M1, we will look to lesser restraint promptly because I think another full quarter of this would put us in a dangerous position where we may be looking at a decline in output by midyear.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. I also think your proposal is a good one, perhaps coming from my view that forecasting is a very tricky business, compounded by the District I come from. Although we've certainly seen improvement, we're one of those very spotty Districts. And even in the firms where we have seen improvement, I would say the attitude is characterized not as any kind of euphoria but as concern about the future. Perhaps coming from my view that M1 does continue to tell us something, I would not like to see snugging up occur at this time. I guess I feel that the danger of inflation in the future may well be reflected in an early way in some of the collective bargaining agreements, and because we have a very difficult [collective bargaining] calendar next year we need to watch [these developments] very carefully to see if more snugging is required at that point. For all those reasons--the state of recovery and the future of the recovery, what M1 is telling us, and the fact that I think we haven't yet seen the collective bargaining process start leading us into a very dangerous area--I favor the proposal you made, Mr. Chairman.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I've been waiting in hopes that someone would say all I wanted to say, and Ted Roberts came very close. No economist is going to agree 100 percent with anybody, so I would come out right where he did except I'd rather use 5-1/2 percent than 6 percent on a quarterly average basis [for M1]. I would stress mainly that if we don't get this growth in M1 in December, we really ought to have a conference call and take a look at it because if that happens, I believe the slowdown might be more real than I now think it is and that maybe we ought to move a little against it. So, I would really go with your original position.

CHAIRMAN VOLCKER. Well, let me try to clarify my original position in the light of all these comments and see whether we can get closer. I am partly influenced by the fact that it's just M1 that is very low and if we write into a directive that we want to increase restraint and have to reverse that very shortly because M1 falls out of bed, it would look peculiar and would be difficult to explain. I must confess that I have that a little in my mind. These seasonal pressures are convenient in the sense that we're getting a little more seasonal restraint for a couple of weeks. I think the split we have in the Committee is between [waiting or not waiting]--not necessarily waiting until we see [the outcome of] collective bargaining agreements or that kind of thing, which would take some months. But if we really get a confirmation of strength in M1, particularly by early January--let's say December comes out more or less as projected and we get another M1 bulge at the beginning of January, so that January growth is beginning to look high and we aren't getting any economic news to suggest anything less than the ebullience we [currently] see--I'd begin moving in a modest way as early as that. I'm talking [about moving] maybe in the first week or second week in January.

MR. ROBERTS. "Bulge" being growth over 6 percent, say?

CHAIRMAN VOLCKER. That would have to be projected for January, but I mean if M1 got off to a [high] start in January. Right now I would say that we should try to make sure we don't get below the $650 million [in borrowing], which means obviously that we would err on the side of more tightness. Borrowing might be more likely to come out above than below $650 million, but we would not be aiming above that level.

Well, let me look at these [specifications]. I would not mind myself knocking the halves off of the alternative B growth rates, or [making them] a little less, if that makes people happier. Let me come back to the federal funds rate later. Specifically, what I would put in the directive is a first sentence that reads: "The Committee seeks in the short run to maintain at least the existing degree of reserve restraint." This would be explained more [fully] in the policy record part. We could move up M1 if you want to. On the M1 sentence, [leave out the reference to] the relatively slow growth in October and just move up that whole sentence on M1 and the credit aggregate to follow the sentence on M2 and M3. That's a very subtle change; I don't think anybody will notice it. They haven't even gotten it yet that it has been moved down. Then I'd make the next sentence read something like: "Somewhat greater restraint would be acceptable should the aggregates expand more rapidly within the context of continuing strength of economic activity." I'd leave out anything about the down side; if something happened and we really wanted to ease--if M1 came in very low, for instance--we'd have to have a meeting.

VICE CHAIRMAN SOLOMON. Suppose we get the continuing strength or ebullience in the economic recovery but we don't get M1 growth, would you still do a little snugging?

MR. MARTIN. And the same lack of any [new] statistical evidence of inflation.

CHAIRMAN VOLCKER. I don't know what we're likely to get in the next two or three weeks.

MR. KICHLINE. We should get the CPI tomorrow as well [as the GNP flash].

MS. TEETERS. And the first Friday in January we get the unemployment rate. That's about it, isn't it?

MR. WALLICH. If you wait until you see it, you've missed it.

MR. MARTIN. Do you want to be too soon or too late?

CHAIRMAN VOLCKER. If you exclude food and energy from the PPI, it was still a rate of only 3 percent. And capital goods was, I think, a pretty good figure all around.

MR. MARTIN. And OPEC is having a terrible time trying to hold the cartel together.

CHAIRMAN VOLCKER. Of the business news that we will get, part of it we'll get tomorrow. But we're now looking at just the first week of January and obviously I can't answer--

MR. KICHLINE. We do get the employment surveys on January 6, which is the first Friday.

CHAIRMAN VOLCKER. Suppose they came in strong. Suppose we got a further decline in unemployment and a sizable increase in M1; that certainly would be a factor on the snugging side. Now, if the [un]employment rate retreated .2 or .3, which I suppose it could just because it was down so sharply the previous two months, we'd weigh that in the balance a little on the other side. If the consumer price index is high, I don't have to tell you on which side of the balance I'd throw that.

MR. PARTEE. It's rather hard to think that we'll get much news except for unemployment. Obviously, there's going to be continuing strength in the economy. The question is: Is it going to be surprising strength?

CHAIRMAN VOLCKER. We would be in somewhat of a dilemma, I suppose, if the employment numbers came in very strong and M1 came in weak. Then what do we do?

MR. GRAMLEY. Well, I think what you do is lean in the direction of the way the economy is going. I think all the evidence is pointing in the direction of an economy that continues to outperform our expectations. I don't know what the flash GNP is going to show, but the housing starts figure this morning alone is going to add several tenths to real GNP growth in the fourth quarter.

CHAIRMAN VOLCKER. I wouldn't be surprised if the GNP growth in the fourth quarter came in around 7 percent. That's my favorite statistic. If it comes out 7 percent, it will be the most rapid three quarters of economic growth that we've had in the postwar period.

MR. MARTIN. If it comes out 6-1/4 percent, as forecast, it won't be the most rapid?

CHAIRMAN VOLCKER. It will be just in that ballpark. Then you would say it's about as fast as we've ever had.

VICE CHAIRMAN SOLOMON. If it comes out at 7 percent, inflationary expectations will increase another notch, even though the actual hard data won't show [more inflation].

MR. CORRIGAN. On this point about prices: If you go back and look at the 6-month period ending in April, the rise in the consumer price index with or without food and energy--any way you slice it--is something like 2 percent. In the six months ending in November, any way you slice it, it's 5 percent or more. Now, I admit that the wholesale price index isn't showing the same thing, but the consumer price index is what gets into social security, other pensions, cost of living adjustments, wage expectations, and the whole ball of wax. I find it very, very difficult to accept the notion that there is no evidence that price increases have started to go up. There is a doubling of the rate of increase--

CHAIRMAN VOLCKER. I don't think there's any question: Prices have gone up [faster] from the midst of the recession and its aftermath.

MR. CORRIGAN. But if the consumer price index is giving the right reading, we're already at 5 percent.

CHAIRMAN VOLCKER. The question is whether it's giving the right reading.

MR. CORRIGAN. I don't know if it is, either.

MR. GRAMLEY. Prices always move with a lag and they always are glacial in their performance unless something spectacular happens on fronts like food or energy. The underlying factor driving inflation is wages, and wages are well known to be very sticky; they move glacially. What we do now is going to affect wage bargaining throughout 1984 and 1985. That is what we have to worry about. And as the economy continues to get stronger--

MR. ROBERTS. I think that is worrying about fighting the last war. The inflation that we're going to experience here comes from things that have happened in the past. If we have a very sluggish M1 series, just because contemporaneously the consumer price index is registering a change that reflects past conditions it would be a mistake to react to that, I think.

VICE CHAIRMAN SOLOMON. But you're talking only about the last four months of sluggish M1 growth. I don't understand.

MR. ROBERTS. No. I'm saying that the prices that will be flowing through the economy are a function of past money growth--say, in the fourth quarter of last year and the first quarter of this year.

MR. GRAMLEY. If you look at what has happened to M1 over longer periods, I suppose you'd look back at the past four years--I would at least--and say that Federal Reserve policy was heavily responsible for the improvements on the inflation front that we have been experiencing. And yet if you look at the figures, you will find out that growth of money in the past four years was every bit as rapid as it was in the previous four years. You have to explain prices other than just by what has been happening to the money stock.

MR. ROBERTS. Well, the trend growth of money is about 8 percent. I don't know what period you would pick, but you would get a pretty closely correlated price change over any longer period of time with the growth of money.

MR. GRAMLEY. I think that is not what the figures have been showing recently.

MR. ROBERTS. You might pick out a cycle and have a deviation.

MR. GRAMLEY. I'm thinking of the period since the Federal Reserve made its historic decision in the fourth quarter of 1979. The growth rate of M1 since then is almost exactly the same as it was in the previous years. The previous four years were a period of substantial build-up of inflation and in these recent four years there has been a substantial unwinding. You have to explain that on grounds other than just M1.

MR. ROBERTS. Well, one way to explain it is that the pattern has been very erratic, which is continuing this year with 13 percent growth in the first half and 5 percent in the second half.

MR. GRAMLEY. We get inflation down with erratic patterns too.

MR. ROBERTS. Well, it creates a different situation than just, say, averaging a year. If you had one [half] at 20 percent and one [half] at 0 and average that out, I don't think it's the same as having a 9 percent year.

MR. BLACK. I have some figures here that I think support both positions, depending on the period you take. In the four years before 1979, 7 percent is the least squares rate of growth; since then it's 6.8 percent. But the first part of that latter period--that would be from '79 to about mid-'81--it was 5.1 percent. And since then to the fourth quarter, it is 10.5 percent. So, that supports your position. It also supports Lyle's.

CHAIRMAN VOLCKER. None of it sounds to me like it supports why the inflation rate was 12 to 13 percent and now is 4 to 5 percent, but that's beside the point. We need to make a decision here.

VICE CHAIRMAN SOLOMON. Maybe the conclusion is that you need an erratic enough policy to eventually bring about a recession that brings down the inflation.

CHAIRMAN VOLCKER. I have described the intentions here about as clearly as I can. What I am proposing, as I understand it, is a pretty quick finger on the trigger if things move in the one direction and no finger on the trigger at all if things move in the other direction. It doesn't mean we can't have a meeting. What we're talking about is that this snugging up, if that is the right term, might well come about early in January. The range of what we're talking about [on borrowings] is $750 to $800 million, depending upon just how the numbers look.

VICE CHAIRMAN SOLOMON. I'd be reluctant, though, to raise the federal funds range for the same reason, even though I know we're getting near the higher end of it. But it seems to me that we're not going to hit the higher end and I think it would give the wrong signal. I think we can continue using the [current] range as long as we retain a money market directive and the markets know it has very little relevance. When we had a more automatic feedback reaction from money supply movements, then it was a reasonable constraint. But why do we bother to continue to put the range in there?

CHAIRMAN VOLCKER. Well, I'll give you three alternatives, none of which I feel strongly about: either 6 to 10 percent or 7 to 11 percent or eliminate it.

MR. BLACK. I'll support Mr. Roberts on that.

MR. GRAMLEY. I think we need a range.

MR. MORRIS. I think it could be eliminated if you tell the market we're following a fundamentally different policy.

CHAIRMAN VOLCKER. That's the problem in eliminating it right at this point. Who wants to eliminate it? Only two Committee members. We won't eliminate it; that proposal has not attracted sufficient support. A 6-1/2 to 10-1/2 percent range doesn't send me. I think we could hit 10 percent. It wouldn't bother me terribly if we do; I don't think we'll hit 11 percent.

MS. TEETERS. Ranges have never been confining.

CHAIRMAN VOLCKER. No. I don't think it's going to confine us all that much either. I think we could hit 10 percent; if we hit it consistently over a period of time we probably would have a consultation. But I don't think that in itself is going to affect anything too much, so I think we're talking about cosmetics here.

MR. BOEHNE. It seems to me that raising it could convey the wrong impression. I think the subtleties that we're talking about here are just that--very subtle. And after all these months if it were raised to 7 to 11 percent, I think it would overstate what is likely to happen and it would also be released in February, which might not be the most convenient time for it to be released.

CHAIRMAN VOLCKER. I don't feel strongly about this. There's something to what you say. The only argument I see on the other side is that we're so close to the top of the 6 to 10 percent range, it looks a little funny keeping it there.

MR. WALLICH. If we're going to raise the borrowing, even though that number is not published, the text of the directive will indicate that it is consistent to have some reaction in the funds rate. It is peculiar to leave it unchanged when the rate is so close to the top anyway.

MR. PARTEE. We're not going to raise borrowings--are we?--unless we decide to snug up, which is getting along into the period. Then the funds rate may go up and then we'll change the range. That's the order in which it ought to occur.

MR. GRAMLEY. I think changing the range would not send the wrong signals; it would send the right signals. I could live with 6 to 10 percent, but I prefer 7 to 11 percent.

CHAIRMAN VOLCKER. How many prefer 7 to 11 percent? Four. [Secretary's note: Messrs. Gramley, Keehn, Morris and Wallich.], How many prefer 6 to 10 percent? Six or seven--an enormous difference. Well, that suggests we leave it at 6 to 10 percent, but it's not a life or death difference as far as I'm concerned.

MR. GUFFEY. Just a matter of clarification: When you make the statement--I'm paraphrasing--that if things go in one direction you have the finger on the trigger, are you talking about the aggregates or are you talking about economic activity? Or do you have to combine those two things before you pull the trigger?

CHAIRMAN VOLCKER. Well, to some extent you have to combine them. But we're not going to get all that much news on the economy, as we suggested. I think that if the aggregates, particularly M1, are running a little high and we haven't in all likelihood gotten adverse economic news, the present sense continues.

MR. GUFFEY. So we are relying a little more heavily on the aggregates because--

CHAIRMAN VOLCKER. Just because of the timing. We could get some very sour economic news. If suddenly everybody stops shopping before Christmas and sales don't look so good--

MR. GRAMLEY. Because they've run out of money?

CHAIRMAN VOLCKER. --and the unemployment rate goes up three tenths of a percent and employment doesn't do much and the industrial production figure for December goes up only two tenths of a percent, all that would give me a little pause. But I don't expect that to happen.

MR. PARTEE. It used to be that in Chicago department store sales were negative the week after Christmas; returns exceeded sales.

CHAIRMAN VOLCKER. Only in Chicago?

MR. PARTEE. If that should be picked up by the newspapers--negative sales--

MR. ROBERTS. Mr. Chairman, do you suggest taking out this modifying phrase about lesser restraint in the context of a significant shortfall of growth in the aggregates? It's in there now.

If we were to have December flat and January developing flat in money growth, wouldn't you want to have that leeway?

CHAIRMAN VOLCKER. Well, what we would have to do is have a meeting. The proposal is to leave it out simply to indicate that there is still some bias toward a little tightening rather than the reverse.

MR. ROBERTS. But if that happens, you would probably have a meeting.

CHAIRMAN VOLCKER. Oh, if they were really flat, I think that's right.

VICE CHAIRMAN SOLOMON. Shouldn't we put in "Merry Christmas" or something like that?

MR. MORRIS. By the time they read it, it's too late. We should say "Happy Valentine's Day"!

CHAIRMAN VOLCKER. The Committee in the short run seeks to have a merry Christmas!

Well, what about the specifications for the aggregates? We can take straight alternative B or, as I said, I'd be just as happy to knock off the halves. Or we could have something different.

VICE CHAIRMAN SOLOMON. It doesn't make any difference.

CHAIRMAN VOLCKER. Very little.

VICE CHAIRMAN SOLOMON. So why spend any time on it? In fact, the advantage of knocking off the halves is that it looks less precise.

CHAIRMAN VOLCKER. You get round numbers; that is precisely right.

VICE CHAIRMAN SOLOMON. People who know what we're doing--

CHAIRMAN VOLCKER. Do you want to knock off the halves?

MR. WALLICH. I would.

MR. PARTEE. Yes.

CHAIRMAN VOLCKER. All right, let me reformulate. We have alternative B without the halves and 6 to 10 percent [for the funds rate range]. "The Committee seeks in the short run to maintain at least the existing degree of reserve restraint." We move up the sentence on M1 and the aggregates to follow the other sentence.

MS. TEETERS. M1 still goes after M2 and M3, doesn't it?

CHAIRMAN VOLCKER. Yes. We can't make a major change in one meeting! And somewhat greater restraint would be acceptable should the aggregates expand more rapidly within the context of continuing strength of economic recovery. Got that? And I am saying all the other changes that I didn't mention there are as in this crossed out [*Bluebook draft version*]. This wording "consistent with the targets" is crossed out. Got it?

VICE CHAIRMAN SOLOMON. Yes. I still think it's more accurate to say "should the aggregates expand more rapidly and/or the economic recovery continue at"--I don't know what word you would want to use, Paul.

MR. PARTEE. Accelerate.

VICE CHAIRMAN SOLOMON. Because the way it reads now we're kind of locked in depending on the aggregates.

CHAIRMAN VOLCKER. Well, I think that is correct technically, but it makes it so fuzzy otherwise. I think that's true of the way it was last time.

MR. GRAMLEY. It might give a little more weight to the recovery if we left the order of the sentence the way it is now: "Depending on evidence about the continuing strength of economic recovery...*somewhat greater restraint would be acceptable should the aggregates expand more rapidly*."

SPEAKER(?) That's correct.

MS. TEETERS. I think that's right.

VICE CHAIRMAN SOLOMON. That's an acceptable way of getting a bit of flexibility there.

CHAIRMAN VOLCKER. Well, yes. I'm not sure it makes a lot of difference to me. It sounds like quite a few of you are just saying that the whole thing would be the same, but we would just put a period after "expand more rapidly."

MR. GRAMLEY. Yes.

MS. TEETERS. And leave out the lesser restraint.

CHAIRMAN VOLCKER. That's all right. All we're doing is putting a period after "more rapidly." Okay.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Solomon	Yes
Governor Gramley	Yes
President Guffey	Yes
President Keehn	Yes
Governor Martin	No
President Morris	Yes
Governor Partee	Yes
Governor Rice	Yes
President Roberts	Yes
Governor Teeters	Yes
Governor Wallich	Yes

One dissent.

CHAIRMAN VOLCKER. Okay. In the boilerplate we'll change the sentence to say that housing starts gained in November, if that's acceptable. I think we'll have to come back to you on the date of the next meeting. I'm not sure about my own calendar at this point, but it will probably be Monday/Tuesday of the previous week, if you don't have problems with that. What we need to know--let Mr. Bernard know--what days you have insurmountable problems on. I suppose we can't go beyond Monday, Tuesday, or Wednesday of that previous week.

MS. TEETERS. January 30, 31 and February 1.

MR. BALLES. I'm having trouble hearing down here, Mr. Chairman.

CHAIRMAN VOLCKER. Let Mr. Bernard know if you have any insuperable problems on Monday, Tuesday, or Wednesday of that week; that's January 30-31 and February 1. Those seem to be the likely days, if we have to change [the meeting dates]. [We can't do it] the week of the 12th since I'd have to testify on the 9th or the 10th.

MR. BOEHNE. You put a high probability on it being that last couple of days in January?

CHAIRMAN VOLCKER. Yes, but I'm not sure.

VICE CHAIRMAN SOLOMON. Is there some advantage to compressing the period?

CHAIRMAN VOLCKER. That's what I'm trying to do.

MS. TEETERS. The problem would be--

VICE CHAIRMAN SOLOMON. Do you need more than one week?

CHAIRMAN VOLCKER. Probably not, that's why the logical day to do it may be on February 1st if I'm testifying on the 8th. We could do it as late as February 2nd, so consider that date too. Consider January 30th and 31st and February 1st and 2nd. The sandwiches are not quite there. We [will end this meeting and] take up this question of the foreign lending program and just dispose of that now if you want to.

END OF MEETING